NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on May 18, 2016 that relates to the reproposal, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*. The other topics discussed during the May 18-19, 2016 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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WEDNESDAY
MAY 18, 2016

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The Advisory Group met at the Washington Plaza Hotel, 10 Thomas Circle, Northwest, Washington, D.C., at 8:30 a.m., James R. Doty, Chairman, presiding.

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BRIAN DEGANO, Associate Chief Auditor
JENNIFER RAND, Deputy Chief Auditor
JESSICA WATTS, Associate Chief Auditor

MS. RAND: Good morning, everyone. This next session we'll be talking about the Auditor's Reporting Model. Specifically, the PCAOB issued a week ago today a reproposal on the Auditor's Report intended to make the Auditor's Report more relevant and informative to users.

This reproposal is hot off the presses. And today, even though we recognize it was only issued a week ago, when we're looking for comments August 15th. But even still, the Standing Advisory Group is a very important group to us and very interested in any initial reactions, comments you may have and happy to answer any questions, too.

Jessica Watts and I are going to spend a few minutes just to provide some background and overview, a little bit about the reproposal. But really we're interested in hearing from you and answering any questions you may have or providing any observations on the changes that have been made and if you think those changes are good which we're hoping we'll hear that. But again, it's up to you.

This project just for some brief background has been several years in the making. We started this back in 2010 and really some of the discussions with the

Standing Advisory Group were really informative to us and the direction of the project and looking to make some substantive changes to make the Auditor's Report more relevant and informative to users.

After we conducted a lot of outreach with the SAG, with investors, auditors, preparers and many others, the PCAOB issued a concept release, held a roundtable. Then in 2013, we issued a proposal. In 2014, had a public meeting.

There has been much academic research coming out which we've considered. Much of that is reflected in the reproposal the Board issued. And also we've been seeing changes that have been happening globally. So talking about an expanded Auditor's Report has become a reality around the world. It hasn't happened here in the United States, but we've seen changes go into effect and have been able to study how those changes have been. Have the investors found the changes helpful? What's been the effect of the audit? And so far, what we've been seeing is a lot of positive results.

As far as the proposal, as I said, the objective has been to make the report more relevant and informative to users. The audit of course involves a significant effort and auditors spend a significant amount of time in order to issue an opinion on the company's financial statements.

The report as it exists today in the United States is a pass/fail opinion. So all this work results in a pass/fail opinion which is very important. It's whether the company's financial statements are fairly presented or not.

But nonetheless investors have asked for more information from the auditor. They view the auditor as an independent third party and are interested in hearing what are really the issues that keep the auditor awake at night.

So that's what our reproposal has intended to do. What it does is it would require the auditor to communicate in the Auditor's Report critical audit matters arising from the audit that required especially challenging, subjective or complex auditor judgment and also how the auditor responded to those matters.

We believe that critical audit matters are likely to be identified in areas that investors have indicated would be of particular interest to them such as significant management estimates and judgments made in preparing the financial statements, areas of high financial statement and audit risk, unusual transactions and other significant changes in the financial statements.

The reproposed standard also includes additional improvements that are primarily intended to clarify the auditor's role and responsibilities related to the audit and to make the report easier to read.

Before I turn it over to Jessica, I'd just like to spend a couple of minutes on initiatives by the regulators and standard-setters. The IAASB, the European Union and the Financial Reporting Council in the UK have all adopted requirements for expanded auditor reporting that go beyond the pass/fail opinion. While their underlying requirements differ in the details, there is a common theme in these initiatives: communicating information about audit specific matters in the auditor's report.

We of course recognize that the regulatory market, environments and other jurisdictions are different from the United States. But even so, we carefully considered the efforts undertaken in these different jurisdictions and we think our reproposal is analogous in many respects to the requirements recently established in other jurisdictions.

We've also been monitoring quite carefully the experience in the UK. At our 2014 public meeting, we had several representatives from the UK talking about their experience. How are things going? Are investors finding this valuable? How are auditors adapting to these new requirements? Have they been able to issue their reports timely?

The FRC, that's the analogous to the PCAOB in the UK, the financial reporting. They're the audit regulator in the UK. They have published a couple of reports regarding implementation after year one and most recently year two. And they have noted that investors greatly value the information provided in expanded auditor reporting, and overall we find the experience in the UK -- and there are a couple of SAG members from the UK that may want to talk about their experience as well -- but we're finding their experience quite encouraging and we're hopeful that the changes to the report, if adopted by the PCAOB, would be well received here.

With that as an overview, I'll turn it over to Jessica just to walk through the requirements. And again we're happy and really interested in hearing your comments today. Thank you.

MS. WATTS: Thanks, Jennifer. Good morning. So as Jen has said, we are most interested in hearing from you. So I'm going to only spend a few minutes on the key aspects of the reproposal and some differences from the proposal.

As Marty did earlier, please feel free to ask questions throughout. Just put your tent card up and we will stop and call on you.

As Marty mentioned and Jen, last Wednesday the Board issued the reproposal for public comment and our comment period ends on August 15th.

I plan to describe a few key aspects of the reproposal including the requirements related to critical audit matters and key changes to these requirements from the 2013 proposal and briefly describe some additional improvements to the Auditor's Report including clarifications of the existing audit responsibilities, disclosure of the auditor tenure and some standardization of the Auditor's Report.

Most significantly, the reproposed standard would require communication of the Auditor's Report of any critical audit matters arising from the audit of the current period's financial statements. While the concept of critical audit matters has been carried forward from the 2013 proposal, the definition has been modified in a number of respects.

Under the reproposal, critical audit matters would be defined as any matter that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective or complex auditor judgment.

The source of critical audit matters has been narrowed to matters communicated or required to be communicated to the audit committee from the matters in the 2013 proposal which were documented in the engagement completion document, reviewed by the engagement quality reviewer or communicated via the audit committee.

The reproposed standard also adds a materiality component to the definition of a critical audit matter because some commenters were concerned that the auditor otherwise may be required to communicate information that management is not required to disclose. By using relates to the critical audit matter which could be a element of an account or disclosure and does not necessarily need to be the entire account or disclosure, or could be a matter that has a pervasive effect on the financial statements.

The criteria by which to determine a matter as a critical audit matter was also narrowed from the 2013 proposal which used the criteria of involved the most difficult subjective or complex auditor judgment, posed the most difficulty to the auditor obtaining sufficient appropriate audit evidence or posed the most difficulty to the auditor in forming an opinion on the financial statements.

It was narrowed to those matters that involved especially challenging, subjective or complex auditor judgment. This change reflects some commenters' concerns that the original definition could lead to the reporting of unimportant matters or to misinterpretation by financial statement users that the auditor is uncomfortable with the related accounting or disclosures.

Under the reproposed standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts and disclosures that are material, the auditor would then take into account a series of nonexclusive lists of factors when determining whether a matter involved especially challenging, subjective or complex auditor judgments.

The list of factors in reproposal is similar to those in the proposal, but has been modified. The reproposed standard includes six factors to assist the auditor in determining critical audit matters. Determination should be made in the context of the particular audit with the aim of providing audit specific information rather than a discussion of generic risks. The reproposed factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective or complex auditor judgment.

Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on only one factor, a combination of factors or other factors specific to the audit that were not in the list that we have provided.

The communication of a critical matter in an auditor's report would include identifying the critical audit matter, describing the principal considerations that led the auditor to determine that the matter is a critical audit matter, describing how it was addressed in the audit and referring to the relevant financial statement accounts and disclosures.

These are similar to the communication requirements of the proposal. However, in response to commenters' suggestions, the new requirement for the auditor to describe how the critical audit matter was addressed in the audit was added.

To meet this requirement, the auditor may describe the auditor's response or approach that was most relevant to the matter, a brief overview of procedures performed, an indication of the outcome of the auditor's procedures or key observations with respect to the matter. Many commenters also stated that the communication of critical audit matters in areas where the company had no current reporting obligation would result in the auditor being the source of original information. That is, disclosing confidential information about the company or effectively imposing a lower disclosure threshold than current management reporting requirements.

The reproposal includes a note that indicates that, when describing critical audit matters in the auditor's report, the auditors are not expected to provide information about the company that the company has not made publicly available unless such information is necessary to describe the principal considerations that led the auditor to determine the matter as a critical audit matter or describe how the matter was addressed in the audit. Additionally, if the auditor determines there are no critical audit matters, the auditor would also state that in the Auditor's Report.

Under the reproposal, auditors would be required to document whether matters that were communicated or required to be communicated to the audit committee and that related to accounts and disclosures that are material to the financial statements were critical audit matters. This documentation requirement has been narrowed from the 2013 proposal which would have required documentation for matters that appeared to meet the definition of a critical audit matter but were not reported.

Several commenters expressed concern that the documentation requirement for nonreported matters was broad and not aligned with current audit documentation requirements. The amount of documentation required would vary with the circumstances and the auditor could comply with the documentation in a variety of ways.

Under the 2013 proposal, the standard would have applied to all audits conducted under PCAOB standards. However, the reproposal contemplates that the communication of critical audit matters would not be required for audits of brokers and dealers, benefit plans or investment companies other than business development companies.

Overall, the Board considered that the communication of critical audit matters for these types of entities may not provide meaningful information in the same way as that for other issuers. However, auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

The next slide provides an overview of the key changes to critical audit matters. However, I've already gone through these throughout the other slides. So I'm not going to spend any time here.

The reproposed standard also includes additional improvements to the auditor's report such as clarifications of the existing auditor responsibilities which would enhance certain standardized language in the auditor's report. As Marty mentioned this morning, we would be adding "whether due to error or fraud" in the auditor's report that has not been there previously, although the auditor has had that responsibility.

Also another one would be tenure. We're going to add an element that would describe how long the auditor has had a relationship with the company and then a statement that the auditor is required to be independent. There is a standardized form of the auditor's report which would require the opinion be the first section of the auditor's report and then requires section titles to guide the reader throughout the auditor's report.

With that I would like to open the floor for discussion. And we are very interested in your thoughts on our new reproposal.

MS. RAND: Again, anything regarding -- you're first.

MS. MURRALL: Thank you very much. And also thank you very much for re-exposing this and pursuing the extended form audit report. It's something we've had in the UK for we're now in our third reporting cycle. And investors have been very appreciative of the moves that have been made.

I'd also thank you very much for the briefing on Friday. I think that was very helpful in advance of the meeting.

As regards the points I'd like to make about what is proposed, I suppose it comes down to the definition of critical audit matters. One of the key criteria for considering whether or not something is critical is that it's material to the financial statements.

However, the PCAOB has refrained from going that one step further and requiring the auditors to disclose that materiality. That is something that is required in the UK and it is something that we have very much welcomed. It allows us to set a sort of benchmark as to what is disclosed.

We also have a concern that the FASB I think has issued a release and it's actually putting materiality in more of a legislative and judicial context and taking away the issuer's judgment as to what users would find necessarily of value.

I also have a concern that the critical audit matters are defined in terms of context of matters that are reported to the audit committee. That, combined with materiality, we feel there is a risk that it could result in a slew of disclosures which really serve to obscure what is going on. We could be swamped by a laundry list.

What I think is very important in this is that auditors display their own judgment and that they've exercised professional skepticism and possibly addressed management's natural bias to present more favorable results.

The FRC-adopted proposals are very much a risk-based approach. We very much welcome this, the risk of material and misstatement and how the auditor addressed them. And we also particularly welcome the fact that a number of firms voluntarily -- they weren't required to do so -- went that one step further and actually described what they'd found as a result of those audit procedures.

I very much welcome what you're doing. But I just have some reservations as to how that may play out in future. Thank you.

MS. RAND: Liz, I'd just like to ask you a follow-up question. You first talked about -- I thought I heard you say two things regarding materiality. And I don't know if it was two things or one.

I know in the UK, the UK audit reports have an additional element that the PCAOB reproposal does not. So that is disclosure of the auditor's materiality.

We do talk about -- we didn't have -- I think we had one comment letter that came in on that point from our proposal. So the reproposal acknowledges that. But we don't have -- we didn't receive interest from that in the U.S. from the 2013 reproposal, the comments that came in.

I thought I heard you say an interest in a similar disclosure in the UK, or were you talking more about just the definition of the critical audit matter component? Or kind of both or -- I just wanted to clarify that point.

MS. MURRALL: In terms of determining what is a critical audit matter I think I had two concerns, A) the dependence on materiality and the fact that that is not disclosed, and B) the fact that the matter is reported to the audit committee and whether or not that could ultimately result in a laundry list and that it's not actually asking the auditor to stand back and say what in their judgment were critical audit matters and where they saw the risk of material misstatement. Does that clarify it?

MS. RAND: Yes, it does. Thank you.

MS. MURRALL: Okay.

MR. BAUMANN: I was wondering, to just maybe follow up. Could you expand a little bit because as Jennifer said we didn't get a lot of comment on the disclosure of what the auditor said as the materiality threshold and doing the audit? We didn't get a lot of comment here in the U.S. that that would be valuable input to the audit reporting model here.

You said you're finding that useful. Could you expand further in terms of that? It would be helpful to hear on the record how you find that to be useful and how you're using it.

MS. MURRALL: In the UK what we're finding is auditors are disclosing first of all how they determine materiality, whether it's percentage of turnover, pretax profit, etc., whether or not they made any adjustments to those figures when they actually determine materiality and also how materiality probably quite importantly had changed if it had changed from the prior year. This really gives investors a view on how detailed, how the auditor dived into those figures in the company, the extent of their testing, et cetera.

I think we found it exceedingly helpful particularly because we are now going into a phase in the UK where we're getting more tendering and rotation of audits to see if we can see whether that materiality changes as a consequence of that, because we think it's giving us a real indication as to the quality of the audit work that's undertaken.

MR. BAUMANN: Thanks. That's helpful and I'll be interested to see if your experience with that and the usefulness you find of that information spurs further comments from others here on our proposal about that. So thank you.

MS. WATTS: Arnold.

MR. SCHILDER: Thanks. I think I can speak for the other ways being not just for myself that we're really pleased with what you have achieved here. Delighted to see the outcome. We're very pleased with the dialogues that you could have.

I recall from the first proposal and the public comments that many noted that there was a lot of similarity between the CAMs with a C and the KAMs with a K. I think what we see now is that it has been much more close even. And I think that's in the very best interest of the users of financial statements and auditor's reports.

So we congratulate you with these efforts, Board and staff. And we thank you for the dialogue.

What we also intend to do to serve the public understanding is that, maybe on Monday, we issue a brief press release with some comments about, let's say, how close it is to what we have with the key audit matters in particular and to complement what you have done and to serve the many users.

Early this morning, Ken Goldman is not here, but he made an interesting point about auditors being proud of what they have been doing. And I thought that was exactly what we have been seeing now with the countries where there is already experience with this new-style auditor's report.

Whether it will be Jimmy Daboo in the UK or Zuleka Jaspera in South Africa that we heard last week in Paris in a panel that you attended as well or Winston Ngan in Singapore or Ron Clark in Australia, all of them express how proud they have been on their profession and what they have been able to do and how they can share it with the audience outside. These are the most complex methods, significance, judgmental, et cetera. And I think that's in the very best public interest.

We have agreed that the IAASB will a post-implementation review of these new auditing reporting standards in a couple of years' time, '18 or '19 or so. That certainly will include the topic of materiality. We have discussed it of course at length in the IAASB. We did not want to require disclosure of materiality because we didn't want to distract from the focus on relevance for users. So key audit matters or critical audit matters have to be the most relevant communications to outside users.

But what we've seen in the UK but also in my home country, the Netherlands, with materiality is quite interesting. So that's certainly something for follow-up.

And I had a brief chat with Maureen on speaking last week at an academic conference. I pointed to the research. I said, this is now a great opportunity for research, cross-border, global of what's happening and how it's going, how you can compare the reports, et cetera.

I'm particularly pleased to see how you have linked it now with the communication of the audit committee. I think that's fully in line with appropriate corporate governance. And it's a good starting point. And then also how you have linked that again with your documentation requirements. I think that is very helpful and responsive to concerns earlier expressed.

Finally, I would say what is most important and that's why it's good that Liz started is that, in particular users will get a lot of feedback on these new-style audit reports, what we have seen in the UK with the investors awards issued by your organization. I think it's very helpful. Now in a way the auditor is back in the public forum. So everybody can engage on this and that's just to encourage everybody to participate in that. So thank you very much.

MR. BAUMANN: Thanks for those comments, Arnold. And I think it goes back to a comment also, Liz, you made about the fact that we did tie our requirements to critical audit matters based upon or derived from matters that are communicated or required to be communicated to the audit committee. And I thought I heard you make a comment about that as well. If I'm wrong. I think you did.

We feel that's the right source. Certainly in the United States we feel that's the right source. And the PCAOB standards as our standard for audit committee communications is quite robust in terms of what is required by auditors to be communicated to audit committees.

So we think that critical audit matters as we envision them would certainly be within the content of what audit committees are required to hear from auditors. And I didn't know if you were expressing a concern about that scope or not in your comment.

MS. MURRALL: I can't say whether or not because it is a detailed list that you have in the AS-1301, whether or not that could actually result in a shopping-list approach to things that are disclosed. The really important thing is the auditor's judgment, not their reporting lines internally to management. But it's the auditor's judgment on the matters that they think should be communicated to investors that's really important.

MR. BAUMANN: Okay. We think that's there, but we would think that those same judgments would apply first of all to their primary responsibility to report to the audit committee, those charged with governance, about those significant matters that they addressed in the audit. So hopefully there's that same population there. That's how we see that. But thanks for that comment.

MS. WATTS: Elizabeth Mooney.

MS. MOONEY: Thanks. I have five recommendations here. Strong supporters of this proposal. And the first is to get rid of the materiality threshold, just echoing Liz's comment. And we gave feedback on some of this over the years.

But in terms of the new materiality threshold and also to get rid of that and also to state, regardless of how subjective a matter is, that if an auditor feels that an issue is important to the audit and it's documented in the memo that it be communicated to the audit committee as well as investors.

And number three, disclose how materiality is assessed. Again, that just seems like that's a must with this project. We have given direct feedback to staff, like I said, over the years with my colleagues. And we have -- the CFA Institute's commented. The IAG found overwhelming investor support for that.

We have the experience in the UK it is useful for gauging audit quality for adjustments and restatements. So I don't see how that can't be part of this proposal.

Number four, disclose whether the audits limit the ability for the audit committee or investors to recover losses. So in the engagement contract there are now alternative dispute resolution clauses being put in there. And investors really need to know if that's the case. It does impair independence by limiting their liability.

And fifth, require disclosure when, in the audit report, when the audit partner was rotated off before the mandatory rotation.

In general, I think it's really important for this proposal to be examined from the standpoint of looking at some of the Valeants, the Lending Clubs, the Chinese frauds, Chesapeake Energy. I mean the list goes on and on of recent examples where investors saw nothing ahead and see what would this audit reporting model have communicated.

I mean this is a communication piece with investors by the auditors. And they're really the real client, the real end customer of the audit report. We are very interested in this communication.

And I think it really reflects poorly on the profession to fight this transparency. So I just urge you to bring some of this to light in a conversation earlier than when the whistleblowers or the hedge funds surface things. And it's a big problem and I think these recommendations will help get us there.

MR. BAUMANN: Elizabeth, those are all interesting comments which we'll certainly take into account and I assume you'll expand on those in a written comment letter.

MS. MOONEY: Thank you.

MS. WATTS: Rick Murray.

MR. MURRAY: First, my appreciation to the staff for the extraordinary amount of effort lying behind the preparation of the proposal and the quality of the materials for the Board meeting.

Question to help put this in the context of the regulatory objective here. Assume that the proposal were to be adopted as currently presented and we are next then in subsequent inspection cycles under these terms. If the inspectors, who would then have the advantage of subsequent event insight, were to determine that the best judgment had not been made with respect to what should have been identified as CAMs but there is no evidence available to the inspectors to suggest that this was a bad-faith judgment even if severely mistaken, would that be deemed for inspection purposes to be an audit deficiency?

MR. BAUMANN: Our inspectors do not try to second guess the judgments of the auditors. They look for reasoned judgments made by auditors at the time based on the facts that they had in any audit area and evaluate the audits in that regard and not based upon hindsight looking after the fact and what they've learned later and not second guessing those judgments.

You've raised a hypothetical situation and we don't have all the facts and circumstances. But just from a principles basis, we're looking for the auditors to communicate the requirements to the audit committee under existing auditing communications standard to the audit committee, and to derive from those as defined in the new ARM proposal those matters that meet the definition of critical audit matters and disclose those and document those which they don't think met and based upon what they know at the time. I don't think that second guessing is an aspect of that.

MR. MURRAY: Marty, the proposal itself describes this as a principles-based suggestion and it may be, although it is far more prescriptive and detailed than the comparable European-based initiatives that are laid alongside this. And it has in reading it so many layers of soft terminology and required judgments that lie behind it. I totally agree with and appreciate your reply that it's not the regulatory purpose to criticize good-faith judgments made in this process.

Given the amount of prescriptive sensation that one gets in reading this, would it be appropriate and helpful if there were to be a statement in the nature, not necessarily a safe harbor, but the intention that you just described, Marty, of we aren't here to criticize good-faith judgments however regrettable they may later be seen to be?

MR. BAUMANN: Thanks for that comment and we'll take that into consideration. But the point is we agree with your point, but it's based upon the auditor's meeting the requirements based upon the facts and circumstances at the time. And it is principles-based standards. But we'll certainly take your comment into consideration. Thanks.

MS. WATTS: Philip Johnson.

MR. JOHNSON: Thank you. As you know I'm a great advocate of this, and my involvement goes back five years when I was president of the Federation of European Accountants. I was right in the middle of the debate with the European Commission with regard to the green paper looking at the auditing profession.

And almost to the week five years ago I gave a lecture in London which I entitled The Accounting Profession: Reinvent or Face Extinction. And the reason for the title was partly to get people there to listen because if it had been the future of assurance, I'm sure people wouldn't have turned up or many people would have turned up.

But more importantly what it was about was because, during that debate in Europe, it was felt by many that the auditing profession was becoming irrelevant. And we'll have this debate later on over the next few days with regard to some of the items on the agenda.

And what I'm pleased to see what happened was that the FRC in the UK did take up the initiative put down by the European Commission, and then subsequently the European Commission have brought it into legislation.

So we've heard the UK has had it for three years. The EU, it is mandated from June 2016. The Netherlands have brought it in. So I do see this as a very positive move. And I congratulate the PCAOB because I think, through the exposure and the comments that have been made and taken onboard, there are really three key areas -- the IAASB Standard FRC which is slightly different including the inclusion of the materiality and the PCAOB have come much closer together.

And I think that is to be commended because we're talking here about the global economy and reporting globally. So the fewer differences, the better.

I think that what will happen in the future is that Arnold mentioned about the post implementation review. Like I said with regard to the audit signature, I don't think it finishes with having a standard. I think these things will evolve and I would hope that matters will get closer together.

So I think we're in a good place, a much better place than probably 12 months or two years ago. So I think we're in a good place.

I was in the profession and I chair audit committees. Looking from the audit committee perspective, it's been very, very interesting to see the difference in engagement of audit committee members, the engagement of audit team members, because now there seems to be a more common purpose.

Audit committees are definitely getting more engaged on what they have to report particularly in the UK, but also what the auditors are reporting. And it comes back to the pride in the work that was mentioned before that the audit team is taking more pride. It's not just a boilerplate report. Their work is being appreciated. So I think that is a great move forward. With regard to the laundry list and whether auditors will disclose too much or too little, et cetera, et cetera, materiality has to come into this. What is important to the investor? I shared a platform with Olivia Kirtley, as you all know, who is the IFAC president, but also is chair of a number of audit committees in the U.S. And we were talking in Paris last week about the relationship between audit committees and auditors and how the role can be enhanced, the auditor's role and the audit committee's role.

Her view was -- and I'm not speaking for her. This is a known statement by her that there is nothing that would be reported that she wouldn't have expected over the years to have been discussed with audit committees. So we're not in new territory. The only new territory really is an external rather than internal focus.

Therefore, there is limited additional documentation that people have to worry about and additional cost, et cetera. I don't see that. We've not seen that in the UK because all that work has already been done. So it's not a great issue.

I and we in the UK do have the advantage as I've said before of having one regulator for governance, for financial reporting and for auditing. That's a great help because the strategic report, the new viability statement that companies have to put out and the audit committee report are mandated by the FRC on the company.

So the story has already been told about the risks within the business. The auditor report is just part of that development of better communication.

So I think, five years ago, I talked about extinction with regard to the audit profession. I think it's turned 180 degrees. Now people see, particularly the investor community, much more relevance to the auditor and the audit process. So I think this is an enormous leap forward, and I commend the PCAOB for making these changes.

MR. BAUMANN: Phil, thanks for those many comments. And I agree with you that what's really great to see as Arnold pointed out naming people, partners, around the world who stated their pride in their work and the importance of their work and providing more useful information to investors that the profession, certainly in those markets where this is already being required, a profession embracing the fact that they're adding increased value to investors through this expanded reporting.

It's great to hear, great to see. And hopefully it will be equally embraced here in the United States. Thanks for all those good comments.

MS. WATTS: Jon Lukomnik.

MR. LUKOMNIK: I wanted to add to the chorus of investors who are thanking you. So consider the chorus filled out with one more voice to the staff and the PCAOB for progressing this.

I do want to however revisit what Liz and Elizabeth said about materiality and address what you said about only getting one comment before. The 2013 release relied, as Liz said, on the professional judgment and of the auditor, as Arnold said, on the relevance judgment, which is why they did not require materiality to be disclosed.

You have now made materiality a gating issue. Once you make it a gating issue, I think we deserve to know how wide the gate is. It seems that there's a linkage that you have put here that, without knowing what the materiality is, it's hard to judge.

I also think, as Elizabeth said -- well, the other change since 2013 is we do have the UK experience. And taking away from the fact that it is a gating issue for the CAMs and therefore I do think there's an -- why would I comment on something that wasn't relevant to the proposal previously? It's now very relevant to what a CAM is. So it's not surprising that you wouldn't have gotten comments in 2013 about it.

However, I do think that the UK experience shows that there is value to disclosing the materiality standard irrespective of the linkage to CAMs. Indeed, I believe the very first investment bank report on the UK enhanced reporting by which I think was CitiCorp -- if it wasn't the first it was one of the first -- talked about how people were surprised by how large some of the materiality standards were. And it engendered a conversation in UK audit committees as to whether or not they had the right materiality standards.

I think that is very much an audit quality issue. So I see no reason not to have it disclosed. And indeed if you were going to make it a gating issue, I think this draft proposal increases the importance of having it disclosed.

MR. BAUMANN: So, Jon, thanks for the comments and we'll certainly take them into account. I do want to say there's a difference between the UK requirement for the auditor to disclose a number they have set for purposes of planning the audit for scoping and terming what is material in the planning of the audit and establishing their audit scope and doing work. That is different than, when looking at a set of financial statements and based on quantitative/qualitative assessments, determining whether matters in the financial statements are material.

There is a difference between those two. It's a subtle statement I'm making. And I think some heads are nodding yes and others maybe are looking at me questioningly.

But one is an auditor scoping decision about what is materiality threshold for trying to set tolerable misstatement and determining the scope of work they'll perform. The other is looking at looking at a set of financial statements and determining are the disclosures that are materially important there and made to the financial statements include all the necessary disclosures and then having critical audit matters pertain to matters in the financial statements that are material, i.e., material to accounts or disclosures.

So there are two different discussions almost taking place there. One is about a scope threshold and one is about linking this matter to items in the financial statements that are potentially qualitatively or quantitatively material.

Having said that, I understand the point that some of you are saying still, the disclosure of the auditor's assessment of scoping level of materiality is important in your understanding of the audit. And that's a critical additional factor you would like to see disclosed. But I do want to make the point that there is a distinction between what we're saying the auditor has to attest for a CAM versus this other point.

MR. LUKOMNIK: I accept that. Generally, the auditor's scoping materiality will be less than what is material in a financial statement. But it is a datapoint.

MR. BAUMANN: It's a datapoint. The materiality for the auditor is, set in the beginning of an audit, is a datapoint. I understand that and I understood the comment made earlier from Liz that that's an important datapoint to see how the audit is viewing that audit when they set their scope and do their plan. What are they setting as the quantitative thresholds for materiality, for scoping.

That doesn't take into account, of course -- it leaves out a big thing, though, what are many qualitative assessments and factors, and that can't really be disclosed by the auditor in that statement that's it's 2.5 percent of net income or something like that.

MR. LUKOMNIK: The fact that you find out that the CFO can't use a calculator cannot be put down. It's fact-specific, I grant you. But I think that to argue that because you can't list all the qualitative factors you shouldn't disclose the quantitative ones really is making best the enemy of better at least from my point of view.

MR. BAUMANN: Yes. I didn't mean to argue the point. We've heard a couple of people say that they'd like to see materiality threshold that the auditor sets disclosed. That's a comment you have and a number of you have made that. So thanks for that.

Brian wanted to comment on this. If I could just go to Brian.

MR. CROTEAU: Thanks. Actually, Marty, thanks for the clarification. I was actually going to make some similar remarks and just thought it would be helpful to reinforce that I think it would be beneficial in the feedback to know what materiality one is looking for for the disclosure. Is it the same materiality management the auditor looks to? And this isn't financial statement materiality which by the way is a legal framework today, looking to the Supreme Court. And nothing with FASB would do for public companies by the way, if they were to do anything, would change that. That's set by the Commission; that's longstanding relative to what the Commission looks to in thinking about materiality.

And then the audit concepts that Marty is describing relative to materiality and planning materiality are a different concept for planning and performing the audit. It would be helpful to understand any comments to the PCAOB I think what the exact recommendation would be and how it might relate to those concepts.

MR. BAUMANN: Sandy Peters.

MS. PETERS: Yes, I raised my hand back when Liz was talking about materiality and was going to echo her comments. But since then I've felt the need to add to that.

You know, I think that we as an organization have asked investors do they want materiality disclosed and the answer is resoundingly yes. But the conversation that's just happened here is one that, by not disclosing materiality, you don't even know these distinctions.

Investors don't know the subtleties of the distinction between planning and scoping and the financial statements and all of these nuances, and that disclosing the materiality in either of these several different ways facilitates that conversation.

Our fundamental problem with the lack of disclosing materiality is that the judgment is being made by people who never talk to investors. So it's being made by auditors who rarely talk to investors, who don't know how they decide whether something is material.

And certainly they can read reports of investors in the company and get a view on consensus earnings which are analyst earnings and the like.

I'm not certain how much that's actually done. But for us it's really about facilitating a conversation with respect to, do you really know what I as an investor think is material. And, oh, you have different views of materiality.

We published the results of our survey which we had done several years ago. We extracted it out in I don't know December or January in response to the FASB's materiality proposal to highlight that we think this is fundamentally a communication issue and that investors don't see it the way that auditors necessarily do.

And to our mind the disclosure of it facilitates communication and an understanding about in fact how people are making that judgment. And so we can come to a common understanding.

I think Philip's point is a good one: that that communication and all of these various communications -- to me, Liz's point is one of well you're communicating it to the audit committee, but the real issue is we want to hear directly from the auditor. And we understand that that may be exactly the same thing. And I understand that the audit is.

But it's a fundamental shift in what investors -- we're hiring management. We're hiring the auditors. We're hiring the audit committee. We want to hear from everybody separately to see if it all hangs together, I think is part of it.

But I think Philip's point of increasing the communication really does demonstrate to investors that there's relevance to the process. And I think shying away from making that communication is really detrimental to the profession because we don't want to give you any information. And I think that's the problem that investors have with the relevance of auditors right now.

MR. BAUMANN: Thanks for that additional clarification and the importance of materiality and how you would use it. Understanding why it's important to investors is very important to us as we consider comments on the reproposal and where we move forward on this particular release. And certainly I would be interested in hearing any other auditor reaction or preparer reaction to your comments and others' comments here about disclosure of materiality.

MS. WATTS: Bob Herz.

MR. HERZ: I've been a long-time supporter of this project and a great admirer of what's going on in the UK the last three years and their boldness in doing it and how I think it's really developed in a way that does help all the parties involved.

My specific comments and I think I made them on the first proposal was I think about two related points that I think Liz made. One was if I read this proposal of the description of the CAM it's kind of optional to include in that what the auditor found. I think it says you could do it. But if you do it, make sure you don't give any impression that you've giving separate assurance on that particular matter, a separate audit opinion on that particular matter.

I don't know. It just seems to me in the context of the discussion, okay, this was the issue. This is what you did. So what?

The second around that point that Liz made is the point about the color commentary and such things like management bias. I think as an audit committee member chair on those kind of matters, key questions, you ask those questions, whether management bias, the way they went about that estimate, is it consistent with how they've done it in prior periods.

I think that kind of color commentary certainly from an audit committee point of view is very important. I don't know whether if I read the proposal, since I asked it as an audit committee chair and the auditor said to me, yes, it's consistent, they're usually right in the middle of the fairway, whether that then would have to be, since it was communicated to the audit committee, would be required in the description of the CAMs?

It's more just a question. I would say my bias is it ought to just because I think that's important information also to the investors.

MR. BAUMANN: Your bias was to what, Bob?

MR. HERZ: My leanings are, if it's important to the audit committee and a good diligent audit committee who is asking those kind of questions and they're important from -- it might be important to compensation, to covenants, those kind of things, they just kind of change it from here in the fairway to here in the fairway. Those are important from an audit committee point of view.

But I could appreciate how reporting it publicly in our regime versus the Jimmy Daboo comment on the original Daimler audit report of KPMG. They said we found this estimate mildly optimistic which I'm sure was their way of signaling like yes, it was really at the fringe kind of thing.

Yet that kind of color commentary clearly, as an audit committee, is very important. I would imagine it's important to investors. I think that's what I heard Liz say. But I also recognize the challenges in our environment in being able to do that in a public report like that.

So I don't have a solution. Just the goal would be to somehow be able to do that or at least encourage it.

MR. BAUMANN: Those are all good comments. And maybe Jessica will comment in a minute. The proposal doesn't preclude the auditor from doing that. And you're precluded from giving a piecemeal opinion on the account or disclosure, or in your disclosure to give an inference that you're not giving assurance on the matter. But otherwise there are some broader words in the release that maybe you can summarize, Jessica.

MS. WATTS: So the release provides or the standard provides an ability or a requirement for the auditor to describe how the matter was addressed in the audit. And so the release goes on to say there are several ways that this could be done. And those would include the auditor's response or approach that was most relevant to the matter, a brief overview of procedures performed, an indication of the outcome of the auditor's procedures or key observations with respect to the matter.

And the critical audit matters, the example that we put into the release has a description of how the auditor responded. So in our case we put in some procedures.

(Off-microphone comment.)

Our examples did not include that. However the proposal does not preclude the auditor from doing that.

MR. BAUMANN: From making further observations, right.

MS. WATTS: Philip Johnson, I know you wanted to respond.

MR. JOHNSON: It's on this very point and this is a big issue because it's the so-what. And we do have to be very, very careful that we don't drive auditors to give a whole series of mini opinions on items on that balance sheet because that is dangerous because the opinion is on the financial statements as a whole.

I know KPMG did with the Rolls Royce example as you mentioned talked about findings. In the UK, that's not being picked up as much as perhaps we thought it might have been because auditors look for competitive advantage.

And the question was, if KPMG did that on Rolls Royce, would others be doing it on other. So you then get into almost a feeding frenzy on trying to find innovative ways of reporting, but I don't think that that has happened.

But it is something I think that we have to be mindful of. And if we give too much latitude, you could get a whole series of mini opinions which is definitely not the place we want to be.

MR. BAUMANN: Nor do we want the critical audit matter not to set piecemeal opinions or a variety of mini opinions, but we don't want it to undermine the overall opinion on the financial statements either. But nonetheless, your comments are understood and taken into account.

MS. WATTS: Sir David Tweedie.

MR. TWEEDIE: Thank you. Can I say that I'm really delighted that we've got to this stage now. I think this is most important project that PCAOB has probably ever done. Most of the others that you've done, if you like, are dealing with the mechanics of the audit. This one is the visible end of the audit. And when you talk about the audit report being the same for 75 years, I mean it's quite shocking really that it stayed that way for so long.

I'm delighted too that you've been very much aware of the international situation. I think it's very important that we take the best of what's out there and you're doing that. There are one or two issues possibly you want to investigate.

I very much agree with Bob and Philip that you looked to this area and what did you find. I thought the KPMG report was terrific and on balance, it only dealt with but five or six issues. But what it did do it gave you the impression that maybe they're overstated it slightly here or understated it there, but on balance, it's a fair presentation. And I thought that gave me great comfort in looking at that particular audit. You really got the feel of what happened in there.

I'm sorry you've had so much resistance to doing this. I remember when I first went to FASB before Bob was there and we're looking at the work program. And you had a pension standard and the timetable was eight years.

And I remember saying that I was a student at university in 1961 when President Kennedy said he'd put a man on the moon by the end of the decade. And I couldn't believe that was less important or less complicated than a pension standard. Experience proved me wrong as it turned out. Any fool can put a man on the moon but getting a pension standard out is something quite different.

So I do understand why you've been held up. But I'm glad you're pressing ahead.

I think the thing that I feel is so important is I think this is terrific for auditors. And I felt quite sorry for auditors in a way. The reason we're all here is because people didn't trust the audit.

So they put an inspection mechanism in, PCAOB, which has been copied around the world. And why was it there? Was it just that you wanted to gee them up? Was it the fact that they were getting a bit lackadaisical?

Or was it probably what people did think that they're too close to the client?

And when you look at Europe, we've had in the last few years the rotation issue. Now why is that there? Well, is it because people think a fresh pair of eyes would be useful or is it the fact that these guys are too close? And I suspect it was the latter. And that's just perception which is harder to change than fact.

And this I think is a great defense against it. Because when you're talking about I'm sorry that this great auditor which all the investors like has got to change you can see the resistance starting to come to that. The danger is if this doesn't get under way and you have another Enron, well why don't we start changing the auditors. And that's the sort of danger.

I think it's a great defense for the auditor. I don't think this is the end of it because I think -- and you heard from Liz and Elizabeth -- the things that they want to see in the audit report.

Well, that isn't a bad idea. If the auditor starts moving more towards the investors and away from the company, I think that's great.

And what do the auditors want to know? I was shocked in your papers when you really started this project to read about the audit report for a company that received a lot of the TARP funding. And the audit report if I remember right in 2008 cost -- Well, the audit cost $119,000 and it was $193,000 in 2009, $74 million. And the audit report was word for word the same.

This is going to be completely different. And I think that's why you want to know so what. You've always had a problem probably with the loan book in that case. And what did you find?

So I think this is terrific. This is changing the dynamics of the audits. And I would press on and as quickly as you can because I think this is something that is going to grow legs. And I would like to see the auditors and the investors getting closer and closer together.

And there's another aspect of this, too, which again is in the United Kingdom, the relationship between the auditor and the regulator, more on the prudential side than the securities regulators yet. But I don't know why it shouldn't be that way.

But it can be the regulator said, we're concerned about X. Make sure you have a good look at that. And that's the sort of thing that I can see the auditor's role in society getting more and more important. And this is the key to it all. And I'm delighted that you've copied the IAASB and the FRC in many aspects. More could be done, but this is a great start. Well done.

MR. BAUMANN: Thanks for that. We are going to pursue ahead very aggressively as we understand the importance of this to investors. So hopefully you'll see a final product before you fly on a plane that's on the balance sheet of the airline that you're flying on.

MR. TWEEDIE: And that took 20 years, the leasing standard.

MR. BAUMANN: Steve Harris.

MR. HARRIS: Sir David, you mentioned Enron. And there have been a number of accounting scandals, Enron, WorldCom, Savings and Loan, 2007, 2008. How would the audit reporting model and the CAMs and the key audit matters that are currently being considered have impacted, if at all, investor perceptions?

MR. TWEEDIE: I think that aspect or whatever it is when you look at an audit -- let's take I think it was

Ernest & Young one when they were dealing with BP. And one of the key issues was the relationship with a Russian joint ventures and that was something I think a lot of people were concerned about. So you know that the auditor is going in there.

Now are you happy with what he says he's done or what he's doing? I think that's the sort of thing, Steve, that can help. This is an area that the investors are concerned about or the regulators are concerned about. He's gone in and he's done this. What's he found? And do you think he's done enough? And that's an issue that can be taken up with the auditor afterwards.

I think that raises a level of the audit. It won't stop the crooks or the guys who are trying to sweep things. But it's a great help.

MS. WATTS: Tom Selling.

MR. SELLING: Like numerous others before me, I just want to start by saying that I think the proposal is a great start, that it will provide real information to users through the audit report, and if the standard is finalized, it will constitute a significant achievement by the Board.

I have two comments that are related. And this actually follows up a little bit on Steve's question. The first one is that I believe an area of CAMs that merits special attention in the standard is the selection of accounting treatments from non-authoritative GAAP.

My concern is partly in regard to the advent of the FASB GAAP codification which was a very good thing. But it changed the protocol that was formerly in auditing standards and that is now in the codification regarding the selection of accounting treatments from non-authoritative GAAP.

For example, it's more likely now that a selection of non-authoritative GAAP might not be consistent with statements of financial accounting concepts because the concepts statements no longer have a special status within that protocol. It would seem to me maybe that should be special consideration of this in the auditing standard, perhaps an illustrative example of when selection of non-authoritative GAAP becomes a CAM, how it should be discussed, and especially when there's a conflict between the accounting treatment and general concepts.

My second point is, my second comment, is that I understand why but nonetheless hoped that the changes made would be more comprehensive regarding other aspects of the auditor's report. I have in mind by this the fact that the Board chose not to reconsider the language in the opinion paragraph even though it needs to be clarified or preferably significantly revised.

I know I have limited time, but this one I'll just talk about five brief situations. Currently, situation 1, the PCAOB says that the audit report -- and I paraphrase -- opines that the financial statements are fairly presented in accordance with GAAP. That's example number one.

Example number two is that at times in the past some auditors used a different phrase. It was presented fairly and in accordance with GAAP. Steve Zeff of Rice reports that 70 years ago the leadership of Arthur Andersen decided that the firm had to straight shooters. Financial statements did not necessarily present fairly when they used accounting principles that were in his judgment not appropriate even if they were generally accepted.

Example number three. Currently, CEO/CFO certifications called for by SOX and SEC rules state that the financial statements are fairly presented in all material respects without a reference to GAAP.

Example number four. The AICPA standards on other comprehensive bases of accounting could state -- and I paraphrase -- that the financial statements are fairly presented in accordance with the modified cash basis of accounting or insert pretty much any so-called comprehensive basis even if that basis is designed by the user itself.

My fifth example. No competent economist would assert that financial data not adjusted for inflation could ever constitute a fair presentation of the data. Yet no matter how much inflation distorts financial statements, they are according to the auditor's report always somehow fairly presented.

So what does fairly presented in accordance with GAAP mean even as a term of art? I know the PCAOB has section 411 to explain fairly presented. But with all due respect, it sheds virtually no light on the investor-communications issue that I'm concerned with.

When speaking to investors, all the words used in the auditor's report should mean something. In all other respects, the PCAOB has done a commendable job in specifying requirements for an informative audit report capable of being expressed in standard English.

Yet in the key opinion paragraph, arguably the bottom line of the auditor's report, critical terms lack literal meaning and effectively construct the facade of gravitas that is inconsistent with protecting the public interest.

In conclusion, I very much commend -- I almost said condemn -- the PCAOB for the progress it's made. But I see it as incremental but important progress. But this is an area that I really feel strongly about and I hope the Board is going to revisit it sometime.

MS. WATTS: Thank you. Chuck Senatore.

MR. SENATORE: I see a number of tent cards and I know we're at lunch coming up. So let me sort of boil this down. One of the things that Elizabeth said that struck me when she talked about in essence, her second point, was if an auditor thinks something is important, let them talk about it.

My quick suggestion -- this is really on the margin, Marty, and this is something that may be very, very subtle

-- is sometimes rules have unintended consequences. And certainly a rule that could end up having an unintended consequence really should be hearing some feedback about the possibility of self-censoring because of a certain standard in a rule that would not be good thing. I'm not suggesting you haven't thought about it and I think this is a great idea.

But the only observation I would share with you -- and certainly this is probably a little bit more of a stark example -- is many times to the extent the more rules people are asked to follow that they tend to actually fit their behavior to the rule.

And the best example from my world in terms of financial services of the broker-dealer regulations you have a Code of Hammurabi of rules that people are footing to the rules, yet the outcomes aren't what they want. In fact you're seeing now kind of reversion to a notion of best practice and best interest of the investor.

So my only point is in thinking about the feedback -- and it may be just a twisted wrinkle -- to the extent that you find that there might be this unintended consequence of a self-censoring because of a gating factor. Just think carefully about it because you wouldn't want to frustrate the spirit of what an auditor could be doing in terms of the value that could be added by virtue of this opportunity with respect to this release.

MR. BAUMANN: Well, a lot of people, a number, have made that point, and I appreciate you echoing it and putting an exclamation point on it. And it is certainly something we think about a lot and we thought about a lot in connection with the reproposal. The concept that because you're required to communicate something, would that shield the communications to the audit committee such that you would avoid ultimately having to report it as a critical audit matter and all of that.

So, something we do think about a lot and we'll continue to think about those comments about self-censoring and make sure that we do achieve the goals that we intend to as part of this, ultimately, adoption when we get to that point. Thanks.

MS. WATTS: Zach Oleksuik.

MR. OLEKSUIK: Thank you. I'll be brief, given time. And first point, we submitted a comment letter in 2013 on this and I won't reiterate all the points here.

In particular, I would highlight -- well, first of all, we are very supportive of this initiative. We do believe, and I believe personally, that the reporting of critical audit matters will indeed be helpful for investors to better understand the financial statements. And this is a meaningful evolution of the audit reporting model, this market.

That said, I hope that the Board and auditors will be mindful of ensuring that the discussion of how the CAMs are addressed provides meaningful, yet not overwhelming, information to investors.

I would highlight a risk of potential boilerplate. We would imagine that there will be companies that will have recurring CAMs year over year. And so the audit report may actually begin to look very similar year over year, over time. So, thinking about ways to keep the report fresh.

But in particular I want to highlight my support, incremental to this discussion here, for the change in scope of the definition of CAM to be narrowly focused on those issues that are communicated to the audit committee. To answer one of the questions that, I think, Bob made about "so what?", as an investor, our first point of contact will be the CFO's office if we've got a question about the financial statements. But our escalation point, and I think our likely endpoint, in discussion of financial statements will be the audit committee.

I don't envision investors having meaningful engagement directly with auditors about any specific issuer. So I think that narrowing that definition is very, very helpful for investors. Thank you.

MS. WATTS: Thank you. Jeremy Perler.

MR. PERLER: Thanks. Let me also say I'm a big fan of this. And just as a bit of a tangible feedback, I work every day, I speak with large investors every day. And in showing them some of what's been coming out of the UK and the CAMs over there, it's been a really positive experience for them. They went in there and do, of course, read through the entire filing. But it was revealed to them there was definite incremental information to how they think about the risks involved or not involved with the company.

And I think that goes to Sir David's point about bringing the auditor closer to investor. I think this is an important topic.

Let me just touch briefly on materiality again. And I think of the challenge a little bit differently, and maybe I'm thinking of it inappropriately. But I understand the concept of materiality of a finite amount, or the difference between two finite amounts, when thinking about the scope of an audit.

Where the challenge in applying materiality to the CAMs arises is these are, by definition, the most complex and subjective judgments in going through the audit. So how do you assess whether a complex judgment or whether an issue that you had is material? Do you look at the entire spectrum of potential outcomes? Do you do several standard deviations away?

For example, if there is a question about applying a particular revenue recognition policy, and that's a complex issue and there are several different approaches that you could take, do you have to recalculate each? Do you think about the most aggressive versus the most conservative way in assessing materiality?

And that challenge, I think, presents itself if you make materiality a gating factor. And it makes, speaking to something like relevance, does the auditor think there's relevance, much easier to do and much more relevant.

MR. BAUMANN: Thanks, Jeremy.

MS. WATTS: Philip Santarelli.

MR. SANTARELLI: Thank you. I guess I'll somewhat timidly weigh into this materiality concept, from the auditor's viewpoint, at least, one auditor's viewpoint.

I think materiality is a datapoint. I don't think it's necessarily a high quality datapoint. I think the process that an auditor does, as you noted, Marty, for planning materiality, that is a number. It's generally a calculation. It's a benchmark. There are various methodologies that firms would use to come up with that first number.

But that's all that it is. It's the first number. And in point of fact, auditors, good auditors will go through the financial statements for individual accounts, transactions, etc., and frankly recalibrate the materiality at somewhat much lower levels, including zero materiality in particular transactions, which comes into the judgments that come around in the qualitative element.

I don't know how we can effectively communicate all of that thought process in an auditor's report without in fact in many ways perhaps losing the audience and what we're trying to communicate.

And I softly reject the concept, the statements that have been made, that lower scope or lower materiality equals a quality audit. I don't believe that. I think, through the process of evaluating audit quality indicators, there has been no empirical evidence that, in fact, that more hours, which is a surrogate or a proxy for that, in fact equals a quality audit. I think better quality hours equals a quality audit. But taking the materiality down to zero I don't think necessarily improves the audit process that much.

So I caution all that think that materiality is a really good datapoint. I'm not so sure without empirical evidence that it is.

MR. BAUMANN: Thanks for adding to that dialogue that alternative point of view.

MS. WATTS: Sri Ramamoorti.

MR. RAMAMOORTI: In the interest of full disclosure, I should say that this materiality thing is so close to me because I wrote my PhD dissertation on the topic of the psychology of auditors' materiality judgments. So I've been thinking about this for the longest time.

And all I can say to all of you is it's the heart and soul of auditing. It is equivalent of the statistical significance levels that statisticians use to make their judgments about what's important, what's significant, you know, that kind of thing, the same kind of idea.

But it is so complex that you go all the way from planning materiality to evaluating materiality to quantitative materiality to qualitative materiality to bandwidth materiality to fidelity materiality. You can keep on going. This is extremely complex.

And so any time you make a disclosure, and that, too, of a partial truth, which is this quantitative portion, I think you are likely to confuse the reader because they will not understand the complexity that is inherent. And in the interest of lunch, I'm going to stop there and leave you all hungry for more.

(Laughter.)

MR. BAUMANN: Just send around your thesis to all of us in due course and we'll look at that.

MS. WATTS: Thank you. Ken Goldman.

MR. GOLDMAN: Boy, now I'm really feeling at risk here with lunch and everything else after that comment. I don't have some of the perspectives that many in this room do. But I do have perspective of the CFO and watching this for many, many years.

And I'll start with since we just covered the materiality. That's a hard one. I see it over and over. It can change during the year given where the company is and its earnings and change in earnings. It can be different from the income statement versus the balance sheet.

I don't know how you could possibly put enough words so the investor could understand what it really means. And so I'm personally totally against putting that in the report.

I think it's one of these things where we're trying to boil the ocean here, which comes to my next point on critical audit matters and so forth. I was thinking about a good example. And to me, a simple example might be you refer to "See the material weakness on material controls relative to XYZ. It's in the report on page XYZ."

It's factual. It gets the reader to focus on that without putting a qualitative assessment as to, you know, how does the auditor feel or not feel about the weakness or whatever.

I think the more you try to put qualitative, the more we're going to be in this room for ten years arguing about this, which is the same thing we had arguing about putting the name of the auditor engagement partner on. I think the more you make it factual, practical, and get these things done, you get things done, as opposed to trying to what I said boiling the ocean and get everything in there, all the whats and ifs and so forth, which just makes it very complicated.

But I think if you can put enough to show the reader to focus on these four or five items and here's where you can find out more about it, that will get a lot accomplished. And it would be a good step.

MS. WATTS: Thank you. Liz Murrall.

MS. MURRALL: Thank you. I'll try and be quick. Neither the UK or the PCAOB have required the auditor to conclude on their findings when they're looking at critical audit areas. We've seen, in the UK, in the first year we had the new audit report, there were three audit reports that reported on the findings, the Jimmy Daboo audits, which we've heard about that.

But it's gone wider than that. The market has responded to investor demand and we saw many more firms in the second year of these audit reports. Deloitte included some conclusions on their findings. PwC did, although it was rather embedded in the work that they'd undertaken. And KPMG reported their findings on nine audit reports.

And I think, interestingly, from KPMG, we understand that they wrote to all their main audit clients. And there was pressure actually from the management of those audit clients not to take that extra step.

I think from an investor perspective that gives us rise for concern. We don't view the findings as a separate audit opinion. But the auditor does a lot of valuable work for investors and reports the report to the members, the investors. And only the auditor can really conclude on the measures that they take. But I don't think it undermines the audit report, you know, the true and fair view as itself.

In regards to the reporting materiality, we have reports from the AQRT, the review team in the UK from the FRC. And that with the increased tendering, they actually produced reports about three or four years ago now, that showed with increased tendering in response to market pressure the audit fees were being driven down and materiality up.

That was a concern. So by disclosing materiality it helps address that. And, yes, probably investors don't probably fully understand what it all means, but only if you disclose it does it give them a hook on which they can ask the questions and gain that understanding. Thank you.

MR. BAUMANN: Thanks. And it looks like, Philip, you have the -- lunch is waiting on your comments.

MR. JOHNSON: Sorry. I've got the lunch is waiting spot.

It's in regard to this -- there's been a lot of debate about materiality. I know in the UK, and we just heard Liz talk about materiality, and I do understand this issue with regard to tendering and driving audit fees down. That's a totality different debate, and I don't intend to get into that.

But from my perspective as an audit committee chair, I actually don't see materiality being disclosed as having much relevance. I mentioned, in my last intervention, when I was talking about the audit committee report, the audit committee report that we've produced basically says what did we spend our time on as an audit committee, what was our engagement with internal audit as well as external audit, what was our assessment of the effectiveness of the audit process and the auditor. But, importantly, what were the major judgments that we looked at in relation to the financial statements? And I think that's particularly important in this context.

And you would expect that there would be some similarity, in that context, between the audit committee report and the auditor's report when you're talking about what were the major judgments that were in there.

And so if we, as an audit committee, are saying what the major judgments were and what we did about them, we would expect the auditor to have a similar view ,and therefore report on what they did to satisfy themselves that those judgments were appropriate.

My audit committee did not for one moment consider materiality. They were looking at what were the key judgments. And I'm quite certain that the scope of the audit was determined through materiality by the auditors. But I don't think that that assessment of what they would report on came into the equation when they were making that report.

I don't think materiality was actually particularly relevant in the reporting process. It's relevant with regard to the scoping. But it's getting less relevant now because with data analytics, which we'll probably talk about later this afternoon, they're using materiality less in assessing that scope.

So I don't think materiality really comes into this. It might be number that investors would like to know. But I don't think it's relevant in relation to reporting.

MR. BAUMANN: Right. You've added to that distinction that I've pointed out before between scoping materiality and assessing materiality as part of the financial statements.

Well, thanks for the very lively and robust discussion of not only the audit reporting model but the other standard-setting matters that I discussed earlier, and the many items that Jim discussed earlier this morning.

So, a very lively discussion. We appreciate all the input. We heard a lot of support for the reproposal here, from those who spoke at least, and a lot of other comments for us to take into account.

With that, thanks very much, Jennifer and Jessica, as well, for the presentation, and for all the SAG members for the input. And lunch time.