

NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board's Roundtable on the Auditor's Reporting Model held on September 15, 2011, that related to the Board's concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards.

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1 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
2 ROUNDTABLE ON THE AUDITOR'S REPORTING MODEL

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11 Thursday, September 15, 2011

12 9:31 a.m.

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21 1201 15th Street, N.W.

22 Washington, D.C.

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

2 [9:31 a.m.]

3 MR. BAUMANN: Well, good morning, everybody.
4 I'm Marty Baumann, the PCAOB's chief auditor and
5 director of professional standards.

6 I want to thank everybody for coming to this
7 roundtable to discuss our concept release on the
8 auditor's reporting model. This is an extremely
9 important project. Efforts are going on not only
10 here at the PCAOB, but in many other places
11 globally discussing the auditor's report.

12 And our concept release asked for comments by
13 September 30th. So we're looking forward for
14 comment letters. We have received several and very
15 valuable ones and looking for more. And we're very
16 interested in everybody's comments today.

17 But with that, let me turn it over to our
18 chairman, Jim Doty.

19 MR. DOTY: Thank you, Marty.

20 Today's open meeting roundtable of the Public
21 Company Accounting Oversight Board will elicit the
22 views of 32 experts that we have around the table

1 this morning. You bring here such various
2 backgrounds as investors, auditors, corporate board
3 members, financial statement preparers, and
4 academics.

5 In this, the third public meeting on today's
6 subject, the PCAOB wants to hear how we can improve
7 the relevance and usefulness of auditors' reporting
8 on the results of their audits of public company
9 financial statements.

10 I want to begin by thanking you, the
11 distinguished group of participants who have agreed
12 to spend the day with us to discuss the PCAOB's
13 auditor's reporting model project. Your active,
14 robust participation here constitutes the most
15 meaningful public service our society asks.

16 Because you each have busy schedules and many
17 other demands on your time, the PCAOB's chief
18 auditor, Marty Baumann, who is chairing today's
19 discussion, and his staff have worked very hard to
20 ensure that your time is wisely and productively
21 used here. We have a full day of discussion
22 topics, and I expect it will be lively. I know it

1 will be valuable to us and to the public.

2 I want to also thank the Securities and
3 Exchange Commission, in particular Chairman
4 Schapiro, Chief Accountant Jim Kroeker, Deputy
5 Chief Accountants Mike Starr and Brian Croteau, for
6 their support for the PCAOB and our inquiry into
7 ways that we may be able to make the auditor's
8 report more relevant for investors.

9 I also want to thank my fellow Board members
10 for their support for and active participation in
11 this project. And before I turn the floor back to
12 Marty, who will invite fellow Board members to
13 offer their thoughts, let me touch briefly on a
14 couple of points about the concept release.

15 The PCAOB's consideration of the audit
16 reporting model is intended to confront questions
17 that recur in times of economic crisis. In the
18 concept release, we attempt to identify meaningful
19 opportunities to enhance the relevance of auditors'
20 communications to investors.

21 Our alternatives aim to enhance relevance and
22 to highlight a statement we made in the concept

1 release -- the alternatives suggested do not aim to
2 change the fundamental role of the auditor to
3 perform an audit and to attest to management's
4 assertions as embodied in management's financial
5 statements.

6 To be clear, they are not intended to put the
7 auditor in the position of creating and reporting
8 financial information for management. So
9 discussion about that may be very important today.

10 As the concept release states, the
11 alternatives are not mutually exclusive. A revised
12 auditor's report could include one or a combination
13 of these alternatives, or elements of these
14 alternatives. Discussants may also suggest other
15 alternatives to consider.

16 We are at a very early stage in this project.
17 The concept release format allows us to frame
18 today's discussion and the broader debate that will
19 play out through the public comment process. It is
20 not intended to lead inexorably to proposed
21 requirements in any of the areas we have suggested.

22 Proponents of ideas, whether embodied in the

1 release or introduced today, should come forward
2 with evidence and analysis explaining why the idea
3 is worthwhile. Both supporters and opponents of
4 changes to the auditor reporting model should
5 present persuasive support for positions they
6 advocate.

7 We are in the middle of a long public comment
8 process. I am confident today will not be the last
9 public discussion of the concept release, but I
10 encourage participants and members of the public
11 who are interested in the project to follow up on
12 today's discussion with any additional analysis or
13 evidence they have to inform and help shape this
14 project.

15 Thank you again, all of you. Thank you for
16 being here, for your interest in the project.

17 Thanks to Marty and the staff. Marty?

18 MR. BAUMANN: Thanks, Jim.

19 Let me now turn it over to Board member Dan
20 Goelzer for some comments.

21 Thank you.

22 MR. GOELZER: Thank you very much.

1 First, I would like to join Chairman Doty in
2 welcoming all of the roundtable panelists here this
3 morning and thanking you for your willingness to
4 provide the Board with your views on ways in which
5 the auditor's reporting model could be improved.

6 Exploring whether to expand what auditors
7 communicate to financial statement users raises
8 fundamental issues about the purpose of the audit
9 and about what it means to be an auditor. The
10 Board has heard repeatedly that investors want more
11 from auditors than the assurance that the
12 traditional pass/fail report provides. Frustration
13 over financial institution disclosures in the run-
14 up to the economic crisis crystallized that
15 dissatisfaction with the current reporting model.

16 As Chairman Doty indicated, to address these
17 concerns, the Board's concept release floats a
18 series of alternatives. At one end of the
19 spectrum, auditors might be required to create an
20 auditor's discussion and analysis commenting on
21 such matters as management's judgments and
22 estimates and its selection of accounting policies

1 and principles. The auditor might also be asked to
2 characterize particular accounting and auditing
3 decisions as "close calls" and to describe the
4 underlying issues and risks.

5 The AD&A proposal rests partly on the notion
6 that auditors had insight into undisclosed risks
7 and dubious judgments on which the pre-crisis
8 reporting of major financial institutions rested
9 and should have alerted investors.

10 In contrast, other concept release
11 alternatives would expand auditors' reporting
12 responsibilities by building on their traditional
13 attestation role without requiring the auditor to
14 compete with management as an information source.
15 For example, emphasis paragraphs keyed to
16 management's disclosures would be a way for the
17 auditor to indicate the existing disclosures that,
18 in his or her view, are the most significant to
19 understanding the company's financial reporting.

20 Auditors could also be required to opine on
21 the accuracy and completeness of information
22 outside the financial statements that management

1 already provides, such as in MD&A or in earnings
2 releases.

3 I have serious doubts about whether financial
4 reporting would benefit from requiring auditors to
5 move from attesting to or emphasizing the
6 importance of information that management presents
7 and into creating their own information about the
8 company's financial reporting. However, as the
9 concept release discusses, even without requiring
10 auditor-created commentary, there is still plenty
11 of room to expand the scope and relevance of
12 auditor communications.

13 In any event, this threshold issue is one that
14 the Board will have to grapple with as the project
15 moves ahead. I am looking forward to hearing the
16 views of roundtable participants on that question
17 and on the full range of possible ways of making
18 auditor reporting more relevant to users.

19 Again, thank you very much to everyone for
20 being here, and I'm certainly looking forward to
21 the discussion.

22 MR. BAUMANN: Thanks, Dan.

1 Now comments from Board member Steve Harris.

2 MR. HARRIS: Thank you, Marty, and I will be
3 very brief.

4 Let me say simply the law states that the
5 purpose of the PCAOB is "to protect the interest of
6 investors and further the public interest in the
7 preparation of informative audit reports." And I
8 stress the words "investors" and "informative."

9 Investors clearly do not believe the current
10 three-paragraph, largely boilerplate, binary audit
11 report is either sufficiently informative or serves
12 their needs. This is apparent from comments made
13 to regulators both in the United States and abroad
14 in the context of the recent financial crisis.

15 So the issue before us today is how best to
16 provide the information in a cost-effective and
17 efficient way directly to investors. And by
18 directly to investors, I mean not wholly funneled
19 through management or audit committees.

20 I asked myself some basic questions. What
21 keeps an auditor awake at night, and what
22 information does an auditor learn from an audit

1 that he or she would want to know as an investor?

2 Why shouldn't auditors disclose to investors
3 that information and the same significant risks
4 they disclose to audit committees? And since all
5 that investors are asking for is what auditors
6 already know, why can't this be done easily and
7 cost effectively?

8 There was a time, going back to the days of
9 Arthur Andersen and Leonard Spacek, that the
10 profession embraced their obligation to safeguard
11 investors' interests. I think we need to return to
12 that mindset and provide investors with more of the
13 information they are asking for.

14 I want to thank Kurt Schacht and Joe Carcello
15 for the surveys they conducted for the Certified
16 Financial Analysts and the Board's Investor
17 Advisory Group, which forcefully demonstrate the
18 desire amongst investors for modernizing today's
19 antiquated audit report.

20 I look forward to hearing from our
21 distinguished participants, and I thank you, Marty
22 and Mr. Chairman.

1 MR. BAUMANN: Thank you, Steve.

2 Everybody should have a package in front of
3 them which includes the concept release, the
4 briefing paper we sent out, an agenda, and various
5 other materials for the day.

6 I'm going to give a brief overview in a couple
7 of minutes of how we expect this meeting to run and
8 operate today. But before we do that, given the
9 size of the crowd and the distinguished group that
10 we've gathered, I'd like to go around the table and
11 ask everybody to please just take a moment to say
12 hello and introduce themselves.

13 So I've done that already, and I'll start to
14 my left.

15 [Introductions.]

16 MR. BAUMANN: Thank you very much.

17 If you take a look at your agenda for the day,
18 what we've planned is for each of the topics that
19 are listed there, we at the PCAOB have asked a
20 couple of people to kick off the topic with some
21 opening remarks. After those opening remarks, the
22 floor will be open to all for comments.

1 I will ask -- I will repeat what we indicated
2 in the briefing paper, that we hope the comments
3 that we get are as specific as possible about the
4 proposals, about your view of the proposed change
5 in the auditor's report, taking into account
6 challenges, implementation issues, as well as what
7 investors' needs are.

8 But the greater the specificity, the more
9 valuable the input will be to us as we go ahead and
10 think about this meeting and think about future
11 possible changes to the auditor's report.

12 After the opening commenters speak on each
13 section, anybody who wants to speak please just
14 turn this tent card up on its edge. We'll then
15 make sure we get around and call on each of you to
16 comment and give your views on the specific topic
17 we are discussing.

18 So, as the agenda indicates, we're starting
19 with the suggested potential auditor's discussion
20 and analysis, then later on moving towards emphasis
21 paragraphs, and auditor assurance in other areas.
22 To the best extent possible, we'd appreciate trying

1 to stay on topic for each of these areas during the
2 morning.

3 We also have a section later on to discuss
4 other alternatives, but certainly, variations on
5 the theme of the AD&A or variations on the theme of
6 emphasis paragraphs would be welcome during those
7 discussions.

8 Opening comments will be made by the following
9 participants, just for your information. In the
10 auditor's discussion and analysis, we've asked Ann
11 Yerger to make opening comments. As you heard, Ann
12 is with CII. Gary Kabureck from Xerox, and Bob
13 Kueppers from Deloitte & Touche will all give
14 opening comments on that subject. Again, after
15 that, the floor will be open to all for comments.

16 In the required and expanded use of emphasis
17 paragraphs, Joe Carcello from the University of
18 Tennessee will kick that off and then followed by
19 Kevin Reilly from Ernst & Young.

20 With respect to auditor assurance on other
21 information outside of the financial statements,
22 we've asked Mary Hartman Morris from CalPERS to

1 lead the discussion initially, followed by Mike
2 Cook, sometimes audit committee chairman, to follow
3 thereafter.

4 And then, the final discussion of the day on
5 the clarification of the language in the auditor's
6 report and a further discussion, an open discussion
7 of other alternatives that participants may have,
8 Jennifer Rand from the Office of the Chief Auditor
9 will lead that discussion.

10 For each topic, we've included questions to be
11 considered. Your comments, when you make them, can
12 be related to the questions or to any other aspect
13 of the specific topic we are addressing. But
14 again, we do ask that you focus your comments on
15 specificity, as we requested in the briefing paper.

16 The outreach we performed, and many people
17 here were parts of that outreach, greatly informed
18 the concept release, and we appreciate the great
19 participation of many people who were part of our
20 outreach. Outreach gave us a lot of insights into
21 what ways the audit report could potentially be
22 changed, but it's this roundtable and comment

1 letters that we're looking for to really help us
2 get more granular in what those changes will be, as
3 we think of changes going forward.

4 As a reminder, I just want to repeat one more
5 time that comment letters are due by September
6 30th, the end of this month. As I said, we've
7 received a number of valuable comment letters to
8 date and hoping to receive many more between now
9 and September 30th.

10 With that, let's begin starting discussing the
11 auditor's discussion and analysis. The questions
12 we'd like to address in the auditor's discussion
13 and analysis -- and again, we can stay on topic
14 with these questions, or you can think of others --
15 but include what types of information should an
16 AD&A include about the audit? What is the
17 appropriate content and level of detail regarding
18 these matters presented in an AD&A -- audit risk,
19 audit procedures and results, auditor independence?

20 What types of information should an AD&A
21 include about the auditor's views of the company's
22 financial statements based on the audit? What is

1 the appropriate content and level of detail
2 regarding these matters presented in an AD&A? That
3 is, management's judgments and estimates,
4 accounting policies and practices, and difficult or
5 contentious issues, including close calls.

6 Next, what are your views regarding the
7 potential for an AD&A to present any consistent or
8 competing information between the auditor and
9 management? What effect will this have on the
10 financial statement presentation? And what are the
11 potential benefits and any shortcomings for
12 implementing the AD&A?

13 So, with that, I will keep these summary
14 questions posted. With that, I would like to turn
15 it over to Ann Yerger for your opening remarks in
16 this area.

17 Thanks, Ann.

18 MS. YERGER: Thank you. Good morning,
19 everyone.

20 Thank you, Chairman Doty, Board members, PCAOB
21 staff, for hosting today's roundtable.

22 I'll speak on behalf of the Council of

1 Institutional Investors, that we greatly appreciate
2 your leadership and, indeed, regulatory courage in
3 exploring some issues that have long been debated
4 and that remain very controversial even today.

5 As noted in the concept release, the quality
6 of the auditor's report has been discussed and
7 debated for decades now. And over the years, a
8 variety of highly respected groups have recommended
9 expanding the breadth and depth of the report.

10 Calls for reform actually haven't ebbed over
11 the years. In fact, I think we could argue they
12 have intensified in the wake of the financial
13 crisis. Most recently, changes have been
14 recommended by the U.S. Department of Treasury's
15 Advisory Committee on the Auditing Profession; by
16 surveys of members of the CFA Institute, which I am
17 a proud member of; by a recent survey of investors
18 by the PCAOB's own Investor Advisory Group; and by
19 the PCAOB staff's own extensive outreach.

20 The bottom line is that investors want more
21 information from the outside auditors. Today, an
22 outside audit of a U.S. company may entail

1 thousands of hours of work, involve reviews of
2 financials produced around the globe, and cost more
3 than \$100 million. But all the investing public
4 generally sees of this tremendously valuable labor
5 is a few paragraphs of boilerplate language.

6 The current pass/fail model does have some
7 benefits. It's brief, and it offers clarity,
8 consistency, and comparability. However, today, it
9 is clear that this report no longer adequately
10 satisfies the information needs of investors, the
11 key customer of this work.

12 An auditor's discussion and analysis section
13 is an ideal approach for enhancing communications
14 between auditors and investors. This supplemental
15 report would maintain the benefits of the current
16 report while satisfying the needs of investors for
17 more relevant and useful information from the
18 auditor.

19 This approach was supported by the IAG survey,
20 which found that a majority of the surveyed
21 investors believe there should be a separate AD&A
22 section in the 10-K.

1 I believe an AD&A should include, at a
2 minimum, the independent auditor's assessment of
3 management's critical accounting judgments and
4 estimates. Such disclosure was supported by 86
5 percent of the respondents to a 2011 CFA survey and
6 79 percent of the respondents to the IAG survey.

7 Respondents to the IAG survey also highly
8 value discussions by the auditor of the following
9 areas: first, high financial statement and audit
10 risk; second, unusual transactions, restatements,
11 and other significant changes to the financial
12 statements; and third, discussions of the quality,
13 not just the acceptability of accounting policies
14 and practices.

15 And I'm not an auditor. I'm not a technician
16 in this space. But I think the feedback from those
17 surveys sort of suggest that investors want a
18 little more color to what the auditors are seeing
19 and what they view about what's being presented in
20 the financials.

21 Certainly, there are risks to a supplemental
22 report, and the biggest is that these reports would

1 become boilerplate and of little value. Clearly,
2 this is not a desired outcome.

3 To avoid this possibility, the PCAOB must
4 write standards for this report. However, I also
5 believe any standards must not be overly
6 prescriptive and that all AD&As should be subject
7 to robust enforcement by the PCAOB to ensure that
8 auditors present reports tailored for each
9 company's particular risks, facts, and
10 circumstances.

11 The benefits of AD&As are many. They would
12 provide investors valued information from an
13 independent expert that is relevant for investors
14 analyzing and pricing risks and making an
15 investment and voting decisions. They would also
16 heighten the perceived value of audit firm work and
17 would give audit firms more leverage to effect
18 change and enhance management disclosure in the
19 financial statements.

20 The end result would be increased transparency
21 to investors and heightened investor confidence in
22 audited financial reports, and that's a good

1 outcome.

2 I strongly believe the additional information
3 should come from the audit firms and not management
4 or audit committees. Audit firms are objective,
5 third-party experts that have unique insights into
6 companies, and it is appropriate and beneficial for
7 the investing public to receive more information
8 directly from these unbiased experts.

9 We would expect that these insights would
10 result in complimentary and not dueling information
11 to that provided by management. This is
12 information that would inform and not confuse
13 investors.

14 Regarding costs, the information of interest
15 to investors is already being communicated by
16 outside auditors to audit committees. So I do not
17 believe the report should significantly increase
18 audit costs. But regardless, I believe investors
19 would say the benefits of this additional, highly
20 valued information would far outweigh any
21 incremental costs.

22 Thank you again for letting me participate

1 today, and I look forward to learning from all of
2 you during the afternoon and morning.

3 MR. BAUMANN: Thanks, Ann, for those very
4 thoughtful opening comments.

5 I'll turn it now to Gary Kabureck for his
6 opening comment.

7 MR. KABURECK: Good morning, everybody.

8 And let me begin by thanking Marty, you and
9 Jessica and the Board, for inviting me to be here.
10 I'm looking forward to it.

11 This clearly is a very important project and
12 one certainly worthy of significant efforts by the
13 Board and the staff. And I'd also like to actually
14 compliment the authors of the concept release for a
15 very readable, very professional document. It was
16 very well done.

17 For today, I'll withhold judgment about how
18 truly critical it is for the current standard order
19 report to change. But that said, I do believe it's
20 desirable and useful to do so.

21 In broad terms, I believe the preparer
22 community will generally support a number of the

1 changes in the concept release, provided the report
2 expansion is reasonably concise and is limited to
3 information about the audit, as opposed to the
4 financial statements.

5 For example, I believe many preparers would
6 support greater use of emphasis paragraphs, where
7 you talk about critical accounting areas, critical
8 audit areas, and likewise, I think you'd support a
9 lot of potential clarifying enhancements in the
10 release.

11 Regardless of where this project comes out,
12 however, I think sooner rather than later I
13 encourage the Board to decide what level of audit
14 knowledge should be presumed to be known by the
15 users of financial statements. While I personally
16 believe it's a reasonable expectation that a user
17 should be assumed to be a knowledgeable reader and
18 can comprehend what is meant by phrases such as
19 "reasonable assurance" and "free of material
20 misstatements," the Board may conclude otherwise.

21 An early determination of what level of audit
22 knowledge should be assumed I believe will greatly

1 aid the Board and the staff in deciding what
2 modifications need to be made to the standard
3 report.

4 Today, I was asked to talk about a preparer's
5 perspective of the concept of an AD&A. While it's
6 certainly not impossible to do, to the extent any
7 AD&A would provide commentary about a company's
8 financial affairs, I submit that you'll find
9 general opposition from the preparer community for
10 a number of reasons -- some conceptual, some
11 practical.

12 For instance, in my view, the auditor's report
13 should not be the vehicle to communicate any new
14 information about a company's finances, accounting
15 policies, quality of earnings, significant
16 judgments, conservatism on the account. If the
17 Board or the SEC or the FASB believes additional
18 information is needed, they should make this
19 concern and address it through normal rulemaking
20 processes applicable to preparers.

21 I think disclosures of a company's financial
22 affairs are the roles of management and the

1 company's board. To require the auditor to provide
2 analysis of a company's financial statements I
3 believe would create some independence and legal
4 issues for the auditors and, let's be realistic,
5 has an awful large number of practical limitations.

6 For example, auditors are experts in
7 accounting and auditing, not operational and
8 financial analysis, and I don't think we should
9 lose sight of this. I think it's also wrong to
10 assume that an auditor knows more about a client's
11 financial affairs than management, but any
12 rulemaking which requires the auditor to comment on
13 a client's financial disclosures and affairs beyond
14 management's disclosures could effectively put the
15 auditor in that position.

16 And there is nothing an auditor could disclose
17 that the client couldn't also disclose.
18 Presumably, management has disclosed everything
19 relevant or required. And if they haven't, the
20 auditors have remedies already available to the
21 auditor.

22 Let's play this out and assume an AD&A, as

1 envisioned by the concept release, becomes
2 required. I think this creates some other problems
3 you're going to need to deal with. For example, to
4 the extent the auditor's disclosures are different
5 or incremental to management's, how to reconcile
6 and explain computing views.

7 I cannot envision a case where an adverse or
8 more conservative or controversial disclosure by
9 the auditor will go unresponded to by the client.
10 I just don't see how investors and other users are
11 better off in such situations to have competing
12 disclosures.

13 We need to be mindful that in some types of
14 AD&A, disclosures may be interpreted as close or
15 contentious calls, when, in fact, this might not
16 actually be the case. Then I would ask what
17 controls and training will there be on the auditor
18 to be balanced in his or her thinking? Will the
19 Board or the SEC provide a set of boundaries and
20 other rules that provide management some recourse?

21 Despite my reservations, should the Board
22 decide to require an AD&A, I would strongly

1 recommend the auditor be permitted to rely on
2 similar and presumably new disclosures made by
3 management, and it would only be the default answer
4 if management does not provide that information.

5 I don't believe a goal of this project should
6 be to increase a company's disclosures through new
7 audit requirements. However, should this be the
8 ultimate direction, everyone, in my opinion, is
9 better off served by having expanded management
10 disclosures rather than expanded auditor
11 disclosures.

12 And my last point just on cost. An AD&A is
13 not going to be free or even cheap. On the
14 contrary, when dealing with external report
15 drafting of this type, this tends to be very
16 expensive time. I personally believe internal
17 audit fees would be better spent diverting the
18 value of this time into increased audit procedures
19 in the high-risk audit areas rather than report
20 writing.

21 So, in closing, I'll go back to the beginning
22 of my remarks. As a preparer, I can see a number

1 of beneficial changes in the standard audit report,
2 provided a focus of the audit process. I want to
3 reiterate that I believe it's inappropriate for the
4 audit report to communicate any incremental
5 information about a company's accounting or
6 finances.

7 If such additional information is ultimately
8 considered appropriate, then I think it should be
9 addressed in FASB or SEC standard-setting
10 processes.

11 So, again, thank you for the time, Marty.
12 Appreciate it. Thank you.

13 MR. BAUMANN: And thank you for your
14 willingness to make some opening comments, and we
15 appreciate hearing them.

16 The third person to introduce this is from the
17 audit profession, and that's Bob Kueppers.

18 MR. KUEPPERS: Thank you, Marty.

19 Let me take a few minutes to set out my
20 thoughts on this topic of auditor's discussion and
21 analysis, or AD&A. And I think my views are
22 consistent with the views of my colleagues in the

1 other firms here today. Of course, if they're not,
2 they'll let me know that.

3 But the reason I say that is we've spent a lot
4 of time -- actually, the better part of the last
5 year -- collaborating, working together on the
6 issues of what the auditor report might be, and I
7 think there are a couple of important points to
8 sort of set the stage for our part of this
9 dialogue.

10 First, I think it's important to understand
11 that the profession is in no way opposed to
12 meaningful changes in the auditor's report. To the
13 contrary, I think responsible changes to improve
14 the relevance and information value of what we
15 produce as auditors is a good thing. That should
16 better serve investors and the other users of our
17 reports as the end product of our work.

18 In fact, we provided the PCAOB with a fairly
19 comprehensive set of examples in a preliminary
20 comment letter just a week after the concept
21 release was published, showing how reports might
22 change under many of the proposals in that concept

1 release. And now these examples are part of the
2 public record, and I encourage you to take a look
3 of so how might it look if certain of these changes
4 were actually made? Hopefully, that will inform
5 the standard-setting process.

6 I will tell you this, informing our views, we
7 developed a short set of what we're calling
8 overarching principles, and I think we'll come back
9 to these throughout the day. And I'll be very
10 brief, but I want to cover them right here.

11 First, we think that auditors should not be
12 the original source of disclosure about the issuer.

13 Management's responsibility should be preserved in
14 this regard. One way to think about it is that we
15 think management should remain the provider of
16 information, and the auditor should be the provider
17 of assurance on that information.

18 Second, changes should enhance or at least in
19 no way diminish present-day audit quality, and I
20 think changes should serve to narrow or at least
21 not widen the expectation gap.

22 I also think it's important to avoid investor

1 confusion. Any revisions requiring investors to
2 sort through differences across information from
3 management, the audit committee, and then the
4 auditor I don't think will be an improvement. I
5 think it will create misinterpretation on what it
6 all means, and auditor reporting should focus
7 largely on the objective rather than the
8 subjective.

9 And finally, I think any changes should be
10 market driven. In other words, they should be
11 called for. What we do that might be different
12 should add value, and I think we have to take note
13 of appropriate cost-benefit considerations.

14 Now, having said that, while we do not support
15 the changes to require an auditor's discussion and
16 analysis as set forth in the concept release
17 because I think it's contrary to the principles I
18 just covered, I think it's very important to just
19 give you a couple of reasons why we think that's
20 the case.

21 Now if we become the original source of
22 disclosure about the issuer rather than management,

1 that is fundamentally changing our role, in my
2 view, and I think it could do a disservice to
3 investors and, in fact, create the confusion I
4 mentioned earlier.

5 We talk about complicated areas like
6 management estimates and the close calls. So, at
7 the end of a robust discussion with the company,
8 the audit committee, and the auditor, a decision is
9 made, but it's in some nebulous category called a
10 close call. Does that mean that that was not a
11 good decision? Does the decision that was made
12 that was not a close call, is that somehow
13 qualitatively better than the one that received
14 more attention?

15 The truth is that the -- when you talk about
16 quality of accounting, variability of estimates,
17 that is the subject of a two- or three-way dialogue
18 with the audit committee, and I find that that
19 process works very effectively. It is hard to
20 capture in a report the essence of a dialogue that
21 happens through the course of an entire financial
22 reporting cycle, and I just don't think it lends

1 itself to a meaningful reporting model that could
2 ever capture the insight or the value of that.

3 So the audit committee, the knowledge of the
4 management, the knowledge of the financial
5 reporting process, and the oversight that they
6 exhibit throughout an entire cycle is something
7 that doesn't lend itself to a few paragraphs in a
8 written report.

9 I think it also changes us, changes our role
10 from being objective to subjective. Our work has a
11 lot of subjectivity, a lot of judgment. When you
12 take that and then have another layer of that in
13 the reporting model, I think you will not find
14 comparability across reports from the same firm.
15 You will not find comparability across reports from
16 different firms in the same industry, and I'm not
17 sure that we, at the end of it all, would say that
18 we have actually improved the system.

19 And I hate to mention it, because it sounds
20 self-serving, but time is a problem. The current
21 reporting deadlines that we face, I can only tell
22 you, and I'll be sort of gentle with this, it is

1 extremely difficult to get it all done, wrapped up,
2 get our papers ready for inspection, everything
3 that has to be done, all within a very compressed
4 timeframe.

5 And with some of our new standards, including
6 new standards for engagement quality review, the
7 pressure just keeps building, and I think this kind
8 of a model would add to that.

9 However, I think we should very carefully keep
10 in mind the problem we're trying to solve. If
11 disclosures are not adequate for the purpose of the
12 users, the investors, the requirements for those
13 disclosures should be changed. Whether it's the
14 management's discussion and analysis, whether it's
15 financial statements themselves, if we're not
16 meeting the needs of investors, that issue must be
17 addressed.

18 And I think there are some very good ways to
19 do that that will give investors what they say they
20 are lacking, and I think management is in the best
21 position to provide those enhanced disclosures that
22 we remain in the best position to provide assurance

1 on those disclosures.

2 And I think some of the disclosures that are
3 on the table today, including emphasis of a matter,
4 some of the potential for assurance on other parts
5 of the document, I think that will come out in the
6 course of our dialogue today.

7 Let me just close by saying I've been around
8 this process from the day that the doors of the
9 PCAOB opened, and I must tell you, Marty Baumann
10 and his staff have done an incredible job of
11 outreach ahead of the concept release. It's sort
12 of unprecedented. I mean, it went on for weeks,
13 months, I'm not sure.

14 But having participated in that process, this
15 is one of the healthiest, most informed concept
16 releases you've ever done, and I encourage, as you
17 go forward, to the extent you have the will or the
18 time, to continue that process. I thought it was
19 just excellent.

20 I look forward to the discussion, and I'm
21 happy to answer questions.

22 Thank you, Marty.

1 MR. BAUMANN: Bob, thanks for your opening
2 comments.

3 I will say during the outreach -- and please,
4 I hope to start seeing tent cards turning up on
5 their edge in the near term. Otherwise, I have to
6 keep talking. Certainly, during the outreach,
7 investors were very strong in their views and
8 amongst a broad group that they needed to hear more
9 from auditors than the standard report that Ann
10 made reference to in her opening comments.

11 And different terms were used by different
12 investors of what they wanted, but the essential
13 issue was it was simply lacking during the
14 financial crisis and over the years in terms of not
15 understanding that there were certain issues that
16 were borderline on the edge and, at the end of the
17 day, could have caused -- would have informed them
18 better had they known about that.

19 So those are strong views from investors, and
20 we wound up calling it AD&A in the press release.
21 That term "auditor's discussion and analysis" wound
22 up being used a lot, but the concept was hear more

1 from the auditor about the types of issues that are
2 discussed with the audit committee. We did hear
3 some concerns from the auditors, et cetera, about
4 some of the problems with that, including
5 timeframe.

6 So, with that, I'm glad to see cards.
7 Jessica, you were up first. I think Mike Cook may
8 have been up first. So we'll turn to Mike.

9 MR. COOK: Thank you, Marty.

10 And my sentiments to you and the staff as
11 well, as have been expressed by others.

12 Appreciation for a very thorough and open-minded
13 approach to a subject that has been studied rather
14 extensively for a rather long time.

15 And maybe I'd just offer one historical sort
16 of perspective on that in that the auditor's report
17 has changed some over the years. We've modified
18 references to uncertainties. Where we used to have
19 "subject to" opinions, the going concern has
20 changed, the use of emphasis has changed. There
21 have been some modifications, but the core of the
22 report and the pass/fail characteristic is not

1 substantially different than what it has been for a
2 long time.

3 There is one thing, though, that I think has
4 changed dramatically during that period of time
5 that should be thought about when we analyze
6 whether or not the auditor's report needs to be
7 changed, and that is the emergency and growth of
8 audit committees. Audit committees did not exist
9 in many instances in the early stages of some of
10 these studies that we're talking about.

11 I can remember being on the Auditing Standards
12 Board 35 years ago when we took up this subject,
13 and it's been lots of folks have had a go at it
14 since then. So it's not an unfamiliar topic.

15 But the point being that audit committees are
16 there for a reason, and one of the principal parts
17 of the process that the audit committees are
18 engaged in is a very robust dialogue and
19 communication with auditors and with management,
20 with others who participate in the process. And
21 lots of what we're talking about here that we might
22 be thinking about putting into an auditor's

1 discussion and analysis doesn't end up in the same
2 environment where there is an open discussion among
3 people in person, live, free flowing.

4 Stating some of that same information is the
5 notion that, "Well, if you say it to the audit
6 committee, why not say it to the investors?"
7 doesn't really comprehend, I don't think, the
8 discussion and the give-and-take and all the effort
9 that goes in to the close calls and things of that
10 kind.

11 So one thing I would ask, I thought this would
12 be better at a gathering of the American Medical
13 Association. But nonetheless, I would say, as I
14 think I've said once before, let's be sure we don't
15 do any harm. Do no harm here to other
16 communication processes that are emerging and
17 growing and getting better all the time and are
18 working quite well.

19 And when you get into some of the notions that
20 are being expressed in different ways and what we
21 have before us today, such as all communications
22 from auditors to audit committees need to be in

1 writing and communications from auditors to audit
2 committees ought to be, in turn, communicated to
3 the public. We start putting those pieces
4 together, and we will drive communications between
5 auditors and audit committees with management back,
6 light-years back from where it is today and take
7 out of the process what I think makes the process
8 really work.

9 So I would make a plea on behalf of audit
10 committee members and people who are working very
11 hard at this to not be so quick to dismiss the
12 effectiveness of that role in the process and leap
13 from the auditor to the investor as if the audit
14 committees were not actively engaged in the middle.

15 And I know you have a separate project on
16 communications with audit committees, and perhaps a
17 high degree of coordination between these two
18 projects might produce a better end result for
19 everybody than we might otherwise get.

20 I'd like to just make an observation about the
21 auditor's discussion and analysis. I think we're
22 all speculating as to what it might turn out to be.

1 And I, for one, if I was a betting person, I would
2 put all my chips on the boilerplate number,
3 whatever that might be, as opposed to betting that
4 this will turn out to be a free-flowing, open,
5 effective communication because I don't see how you
6 can overcome the potentials from inconsistency from
7 person to person, from company to company, from
8 industry to industry, from firm to firm.

9 And to the extent we end up with something
10 which is very different from company to company and
11 firm to firm and so on, I think the inconsistency
12 of that and the confusion that that will create,
13 perhaps almost chaos that that will create, would
14 detract so much more than any benefit that would be
15 derived from it.

16 So if you end up with speculation A,
17 boilerplate, probably not a great deal of harm,
18 just cost with no benefit. If you end up with the
19 alternative, I think you end up with a potential
20 for substantial decline in the overall quality. so
21 I would suggest we need to be very careful at what
22 the standards are and agreeing with Ann saying they

1 should not be prescriptive. But at the same time,
2 this can't be a free-for-all.

3 And I would urge one thing, and that is if the
4 inclination is to move forward with AD&A that, in
5 addition to the great outreach you've done up to
6 now, this needs some serious field testing because
7 I think the issue of timing, which Bob points out
8 is critical; the issue of how management will
9 interact with what the auditor is saying in the
10 discussion and analysis; the what the content is
11 going to be, what is it going to look like, how is
12 it going to be presented should not be done in a
13 vacuum.

14 So I'm not a fan of this. I'm not
15 enthusiastic about it because I still believe the
16 boilerplate is going to win out in the end. But if
17 we are going forward, I would say do so with great
18 care.

19 MR. BAUMANN: Thanks, Mike.

20 And I can assure you that the staff and the
21 Board will certainly encourage us to work with due
22 care on this most important matter, and we'll

1 continue to, hopefully, go about this with the
2 thoughtful way in which many of you have
3 complimented us for moving along so far. So thanks
4 for those thoughtful comments.

5 I'd like to turn to Joe Carcello.

6 MR. CARCELLO: Thanks, Marty.

7 First of all, I think Ann did a wonderful job
8 of laying out the case for AD&A. So I won't
9 reiterate what she said, and I thought Gary and Bob
10 and Mike's comments were very good, very
11 thoughtful. I disagree with much of it, and I
12 could try to rebut it, but I won't do that at this
13 point.

14 I do want to point out -- since in this forum
15 in the past at times I have been critical of the
16 profession when I think their performance has
17 fallen short, I do want to reiterate or second what
18 Bob Kueppers said about the CAQ comment letter, and
19 I've said this to Sam and others in other public
20 forums, I think it's actually a very good comment
21 letter.

22 The profession has gone further than I thought

1 they would. Not as far as I'd like to see them go,
2 but further than I thought they would. And in
3 particular, Marty, I would point out to you in
4 Exhibit A, Item Number 4 on page 4, I think is
5 quite good. I think that's the kind of information
6 that investors are really driving at. So I give
7 the CAQ and their members credit for that.

8 But what I want to talk about very briefly is
9 we're hearing a lot today, and I think this is
10 really one of the essential issues -- maybe the
11 most essential issue -- is that auditors shouldn't
12 be --

13 MR. BAUMANN: Just as an aside, that Exhibit A
14 is not something that everybody has in front of
15 them. You're referring to the Exhibit A to the CAQ
16 letter.

17 MR. CARCELLO: CAQ comment letter.

18 MR. BAUMANN: That's not in front -- it's on
19 our Web site, but it's not in front of everybody
20 today. I saw some people looking through their
21 folders.

22 MR. CARCELLO: That's right. It's not in

1 front of everybody today.

2 The essential issue is whether the auditor's
3 role in doing more direct reporting is appropriate
4 or inappropriate, and I think that's probably the
5 major source of tension. So I just want to do --
6 very briefly make a couple of comments not from Joe
7 Carcello, but from the profession itself.

8 And so, I have a comment here. This is from
9 testimony before ACAP by Dennis Nally -- Mike, your
10 boss, I guess, or one of your bosses -- the
11 chairman of PWC International, who stated, "It's
12 not difficult to imagine a world where the trend to
13 fair value measurement leads one to consider
14 whether it is necessary to change the content of
15 the auditor's report to be more relevant to the
16 capital markets and its various stakeholders."

17 And in the white paper that the CEOs of the
18 six largest firms produced in 2006, they stated,
19 "The new reporting model should be driven by the
20 wants of investors and other users of company
21 information."

22 Also in that same white paper, they stated,

1 "Given our independence and experience, we, the
2 auditor, are in an ideal position to provide value
3 to investors throughout the world." We agree with
4 them. We agree with them.

5 The last thing, and this is from a book
6 written by Sam DiPiazza, who is a former CEO of PWC
7 and one of his colleagues, and I'm quoting now from
8 this book, "Making the future better requires
9 responding to the market's demand for audit
10 opinions that say more about the information on the
11 health of the business. Today, a great deal of
12 this information is already reported by management
13 and for certain purposes is considered in the
14 course of the audit, including such issues as
15 management estimates, the possibility of fraud,
16 risks, liquidity, and future scenarios.

17 "The audit opinion" -- I'm still quoting.
18 "The audit opinion could be expanded to address
19 this information, as well as how all the pieces fit
20 together as a whole."

21 So we're in agreement with everything I've
22 just said there, and I guess my question to my

1 friends in the profession is what's changed?

2 MR. BAUMANN: Joe, we appreciate those
3 comments and all of the research that you've done
4 on our behalf. And we'll look forward to your
5 ongoing research to support our efforts.

6 I'll turn to Mark Newsome.

7 MR. NEWSOME: Thank you.

8 The first thing from my perspective over the
9 years is the audit opinion generally has not
10 provided much value. I typically look to see if it
11 was unqualified or not and if there was something
12 added after that, you know, some type of change in
13 accounting policy.

14 And so, when I started to think about this
15 invitation -- by the way, thank you for inviting me
16 -- I started to think about what would be nice to
17 see in an audit opinion and what I've seen through
18 other channels in my investing career.

19 And so, the first thing is I think about what
20 and auditor did review, right? An example might
21 be, as an analogy, a legal opinion that I might see
22 in a private investing transaction. There's a

1 negotiation that takes place where the company's
2 counsel will provide an opinion and explain what
3 they reviewed and what they did to come to that
4 opinion.

5 When I think about close calls, I think about
6 not necessarily a contentious situation or, "Boy,
7 that was a close call" type of conclusion. But I
8 think about the range of possibilities that might
9 have been discussed.

10 For example, if you're talking about a
11 particular figure on a balance sheet, was the
12 probability chosen equal among five possible
13 outcomes, and they settled on one? So then, maybe
14 the auditor should discuss the fact that there was
15 a wide range of possibilities that were relatively
16 equal and potential conclusion.

17 When I think about coming back to the
18 unqualified opinion, I think about accounting due
19 diligence reports that I've seen where, let's say,
20 an investor would hire an auditing or accounting
21 firm to render some form of opinion on a company's
22 financial profile. And those reports are generally

1 rich in information, and they provide a lot of
2 value, whereas the audit for public and private
3 companies opinion does not.

4 And then when I think about the boilerplate
5 comments, my opinion of companies across my career
6 is that each one is different, even within a small
7 peer group where companies do generally the same
8 thing. And I know that the management financials,
9 not necessarily the audited financials, the
10 management financials are generally different from
11 company to company.

12 And so, if that's the case -- and I encourage
13 management teams to use their own style because I
14 believe the financial statements are a tool to help
15 me understand how they run their company. And so,
16 if management financials are different even within
17 peer groups, then why should the audit opinion be
18 identical for companies within a peer group?

19 And so, I have lots of other comments, but let
20 me stop there and, again, thank you for the
21 opportunity.

22 MR. BAUMANN: Thank you.

1 Steve Buller?

2 MR. BULLER: Thank you, Marty, and thank you
3 for inviting us to speak this morning.

4 So I have a number of general observations and
5 then a few specific observations with respect to
6 the questions you've asked.

7 So, as part of BlackRock, we actually polled
8 the analysts globally to get their input from our
9 firm and also our preparers. So BlackRock
10 preparers roughly -- it is subject to audits on
11 roughly 3,500 sets of financial statements between
12 the corporate entities we have and all the funds.

13 I was afraid for a while, as I was getting
14 these very passionate views on both sides, that I
15 would be issuing the reciprocal of the SEC
16 disclaimer that the opinions were those of my
17 company and not my own. But we've reached some
18 agreement where they actually are my opinions also.

19 As part of our challenge in issuing all these
20 statements, many of our statements that we have are
21 SEC registrants, and particularly on the fund side,
22 and those statements are included in the financial

1 statements of other nonregistrants in the U.S., as
2 well as local registrant and nonregistrant entities
3 overseas.

4 So one of our general observations is that we
5 really believe it's important that as part of this
6 undertaking, which we believe is important and very
7 useful, that there be a collaborative effort
8 between the PCAOB, the AICPA, the SEC, the FASB,
9 and certainly the IAASB in making sure there is
10 some alignment to the extent possible in the audit
11 opinion effort because we think it might be
12 difficult for many of the users of our statements,
13 who are global users, to see different sets of
14 opinions that might have different levels of
15 content. So, to the extent that those can be
16 developed in a parallel fashion, that would
17 certainly be useful.

18 So, in addition to that kind of global
19 perspective, we also believe, and I think Bob made
20 the comment from D&T, that it's important to have
21 statements around objective as opposed to
22 subjective information where possible. And we

1 believe there are a number of objective criteria in
2 the A&A which do benefit from comment.

3 And thirdly, again, a comment made by several
4 people is it's important that management, where
5 possible, be the original source of disclosure
6 about the company. And again, we think there is
7 value to having a review by the SEC and other
8 entities in the materials that are contained in S-K
9 to see if some of those should not, in fact, be
10 moved to S-K because some of the disclosures that
11 now are being made or should be made perhaps in
12 MD&A could be subject to auditor oversight and,
13 therefore, a higher level of assurance by the user.

14 So, with respect to some more specific
15 comments, we do believe that the AD&A could be a
16 useful tool, but there should be some parameters
17 around the content of the AD&A. And among those
18 are I think that it would be useful to have
19 information on -- pointing on significant new
20 accounting principles and whether they are
21 preferable in the context of authoritative and
22 regulatory guidance. So, again, something that is

1 subject to a specific definitive benchmark, as
2 opposed to a subjective determination.

3 We also think that our users in particular
4 felt that there were a number of situations where
5 they would have benefitted from additional
6 information on going concern entities. So they
7 thought that whether our issues involving
8 uncertainties, that those -- the insight on those
9 uncertainties, declining or concentrated cash
10 flows, upcoming material financial obligations,
11 changes in other characteristics of the operations
12 of the company, that insight, if not communicated
13 by management, would be very helpful to have in the
14 AD&A.

15 There also are some areas related to auditor
16 independence. And so, we think the AD&A could
17 benefit from a couple of different segments to it.
18 One is general observations on audit procedures,
19 some on the company, and then on auditor
20 independence because not all aspects of auditor
21 independence are, in fact, disclosed in a proxy.

22 So we, of course, have our audit fees

1 disclosed in our proxy. We have a number of
2 related party arrangements, including audits of our
3 funds that we sponsor, that do not appear in the --
4 the fees don't appear in the proxy or other
5 disclosures. And we think it's important for
6 investors to have some perspective on the overall
7 relationship that the auditor has with a
8 registrant, which may be both direct through the
9 fees paid by the registrant as well as indirect
10 through those services provided to affiliates and
11 related parties that can be audit and not audit
12 services that could bear upon independence.

13 We also think it would be important to have
14 information on the tenure of the audit
15 relationship, again as part of that overall
16 disclosure in the AD&A.

17 We think that there are some areas that,
18 again, would be helpful to investors, and that
19 would be disclosure of audit procedures and
20 material errors. Now this is a catch-22 because we
21 don't want the AD&A to be a 45-page document
22 talking about every specific procedure performed.

1 But we do think that there are material errors
2 where at least it would be helpful to allow the
3 investor to have some insight into those
4 significant judgments regarding uncertainty with
5 respect to some of the sensitive areas like fair
6 valuation, review of the impairment of intangible
7 assets, loan loss reserves, tax uncertainties, all
8 those things which have been the flashing red
9 lights in the reports over the past several years.

10 We would not object to the identification in
11 AD&A of those areas which were -- where there is
12 significant management or auditor judgment or
13 significant uncertainty, given their complexity
14 and, as part of that, the attendant disclosure of
15 some of the key inputs upon which the auditor
16 relied.

17 And again, part of the thesis that we believe,
18 which is based upon the need for management to make
19 original disclosures, we believe that will in part
20 force management to enhance their disclosure and
21 their financial statements, as opposed to having
22 the auditor talk about their key inputs. Because

1 we believe that many of the key inputs that the
2 auditor uses in performing their procedures also
3 are the same key inputs that are used by
4 management. Not in all cases, but we believe those
5 would benefit from that.

6 Responding to the comment on close calls that
7 was made, and I forget who made that, we really do
8 not support disclosure of close calls because it
9 almost has a pejorative nature to the assertion
10 because it sounds like that there is a toggle
11 point, and that toggle point is a close call when,
12 in fact, the very nature of preparation of
13 financial statements involves estimates and a level
14 of uncertainty. And it would be perhaps misleading
15 because it almost implies that there is a failure
16 to adopt proper accounting principles or the
17 failure to have an appropriate determination on the
18 accounting issue.

19 So we believe there are other ways to
20 communicate that. One of those is in the MD&A
21 section, many firms are encouraged by the SEC
22 literature to include ranges around estimates. We

1 believe that that literature should be clarified to
2 make it clear that information should be prepared
3 by the registrant, included in financial statements
4 to provide more insight on the nature of that
5 uncertainty, as again opposed to a statement by the
6 auditor that there was a close call may imply that
7 something is wrong when, in fact, all there is, is
8 a determination made around a range of possible
9 outcomes.

10 Again, I think in the MD&A, it's important to
11 the extent that there is also forward-looking
12 information that that forward-looking information
13 be made by management and that the auditor be
14 restricted to objective comments and does not go
15 beyond those points.

16 And I think those are probably the significant
17 statements that we'd like to make.

18 Thank you.

19 MR. BAUMANN: Thanks, Steve.

20 Can I just follow up a little bit, just want
21 to make sure I was clear on the point you were
22 making on the insight with respect to judgments and

1 estimates. Were you talking about the insight with
2 respect to what audit procedures were performed by
3 the auditor on those judgments and estimates, or
4 about the auditor's insight as to the quality of
5 those judgments and estimates made by management,
6 or both?

7 MR. BULLER: So it would be based upon to the
8 extent that there are audit procedures performed,
9 it would be clarification around those procedures
10 performed. So it, in fact, points the reader to
11 understanding that there are areas of significant
12 judgment.

13 That to the extent that there were inputs that
14 were used in making those determinations by the
15 auditor, potentially disclosure of those inputs so
16 the reader would have some understanding of the
17 basis upon which the auditor reached their
18 conclusion.

19 MR. BAUMANN: Thank you.

20 Just so those whose cards are up, brief order
21 I have right now is going to be Bob Guido, Jack
22 Ciesielski, and then Mike Santay. And now I do see

1 other cards up, but just knowing you're going to be
2 called on.

3 MR. GUIDO: Thanks, Marty, and I appreciate
4 the invite.

5 Many of the things that I'll mention have been
6 addressed by a lot of you already. I'm all for
7 changing the auditor's report in a very
8 professional way. I've been dealing with the
9 expectation gap for nearly 45 years, both from a
10 public accounting standpoint and the last 5 1/2
11 years as an audit committee chair.

12 But again, I'll -- not quite as long as Mike
13 Cook, by the way. But having said that, I do agree
14 with what Mike said. And Steve, some of your
15 comments just now, I do agree with.

16 I might start off by saying that in my mind,
17 the auditor's report provides assurance that the
18 financial statements are presented in accordance
19 with GAAP. I really believe that provides a lot of
20 value. So I personally take exception to anyone
21 who doesn't believe that.

22 The audit is historical. There's no question

1 the opinion is a point in time. It's not
2 predicting the future. And if we need to focus
3 more on the future, then we need to change a lot
4 more.

5 I would say that in Mike's summation about
6 audit committees and usefulness of audit committees
7 and what they really have been doing -- and I've
8 been a little bit spoiled in the profession because
9 I had some great audit committees that I worked
10 with. Then I had some not so great ones in the
11 '70s and '80s.

12 But Sarbanes-Oxley really changed the game
13 plan, and a lot of great things came out of
14 Sarbanes-Oxley, in my mind. And the audit
15 committee arena, which Mike mentioned and I fully
16 agree, really needs to be studied more, where we
17 are and where we're going, because there's a lot of
18 great things happening, in my experience, with
19 audit committee and audit committee institutes
20 across the capital markets.

21 Today's markets, I would also say, are much
22 more sophisticated, and the investors,

1 institutional investors, the analysts that I deal
2 with ask great questions. Their predictive models
3 are wonderful.

4 However, as an audit committee chair, I really
5 am concerned that many suggestions in the AD&A
6 could make the committee's oversight of the audit
7 and communications with the external auditors much
8 more difficult without providing the promised
9 benefits to the ordinary investors. Providing
10 investors with the same information that is
11 provided to audit committees without the context
12 obtained from a two-way dialogue may be incomplete,
13 generate, in my mind, greater confusion, and not
14 enhance the overall understanding of the readers of
15 such a report.

16 I've also great concern that the notion of an
17 adoptable report that he or she could tailor to a
18 company's specific risks, facts, and circumstances.
19 This, in my mind, would lead likely to an
20 administrative nightmare in trying to wrap up an
21 audit, given that each report would be custom made
22 and would likely have to be cleared with the

1 national office, accounting and auditing experts,
2 let alone legal.

3 The resulting report, in my mind, would be
4 extremely long and complex. It would probably lack
5 comparability with other companies and would likely
6 not be in a format that easily can improve
7 communications with users. And again, remember,
8 that's what we're trying to do here.

9 And last, but not least, I have a real concern
10 that at least in my boards, I want the audit
11 partner to really focus on the risk and the
12 complexity of what they're doing and prove audit
13 quality and not worry about haggling over a lot of
14 words. And I'm very concerned about that.

15 Thank you.

16 MR. BAUMANN: Thanks very much, Bob.

17 You've probably been observing the same thing,
18 but I just want to maybe summarize a little bit
19 because I'd be interested that as you are making
20 your comments, those who think an AD&A is a good
21 idea, those who seem to have expressed concern
22 about it during this session have talked about

1 timing and how it could impact 60-day reporting
2 deadlines at year end.

3 The fact of a lack of context maybe that the
4 two-way dialogue had between audit committee
5 members, or three-way -- audit committee members,
6 management, and the auditor. And some concerns
7 that those who were expressing that about
8 inconsistency, since individual partners would be
9 writing the AD&A, inconsistency within a firm, I
10 guess, with respect to various clients and then
11 certainly between firms and industries. And those
12 are some of the concerns being expressed, and we
13 heard those in our outreach.

14 And I guess to the extent those who have their
15 cards up who think AD&A is a good idea, how do they
16 think that we could work around that as a concept?

17 So please comment on whatever you want, but I just
18 -- those are some consistent themes I hear, and I
19 just am interested in those who have -- believe the
20 AD&A is a good idea maybe to comment on those.

21 As I said, Jack Ciesielski was going to be the
22 next commenter.

1 MR. CIESIELSKI: Thanks, Marty.

2 If I could just tack on to what you just said,
3 obviously, I support the AD&A concept, but I don't
4 think that it has to be a replacement for the audit
5 opinion. It's a supplement. Therefore, I think
6 you could expect to have variability from client to
7 client and within a firm.

8 If you think about the MD&A as a model, the
9 MD&A wasn't exactly, I think, welcomed by companies
10 when it was first initiated. But it's evolved and
11 developed, and it's not a bad framework for
12 thinking about the AD&A. It's custom tailored to
13 each individual company. There really isn't much
14 comparability from one MD&A from one firm to
15 another, and I don't think investors would expect
16 one AD&A to be the same for two companies in the
17 same industry, even if they're audited by the same
18 firm.

19 The way I read the concept release and the
20 understanding that I have of what an AD&A should be
21 is a communication between the investor and the
22 auditor. And I think when we start worrying about

1 having competing disclosures with management's
2 disclosures, I think we're muddying it up a little
3 bit because it's really quite clear in the concept
4 release that this is not intended to contradict or
5 supplement the management disclosures. It really
6 should be about the relationship between the
7 investor and the auditor, which you don't get much
8 of in three paragraphs right now.

9 I think, actually, if you're going back to the
10 analogy of the MD&A, one place that auditors
11 typically begin their audit is with an assessment
12 of the risks within the company in the operating
13 environment they participate in. So I think it
14 would be very useful for an investor, just to throw
15 away -- getting away from the close calls issue,
16 but what would be good for an investor?

17 I think it would be good for an investor to
18 understand how the auditor assessed the risks
19 within the firm before they began the audit, how
20 the economy, how their competitors might have
21 effects on the assets and liabilities of that
22 particular company.

1 There could be competition that's making their
2 product obsolete. It might encourage the auditor
3 to expand their testing of inventory or accounts
4 receivable because maybe their products that
5 they've already shipped are already obsolete, and
6 they have problems with customers.

7 But understanding the environment that the
8 company operates in is central to the audit, and
9 sharing that assessment with the investor would be
10 useful from a very broad, high-level kind of
11 assessment, and that could be communicated and how
12 that affected the way they performed the audit.

13 I don't think that the investor wants to have
14 an audit program in an AD&A, but I think they want
15 to know why the accounting principles employed by
16 one company are sufficient. Not just because
17 they're in GAAP, but what makes them preferable?

18 If I could give an example that's something
19 happening right now? We've had pension accounting
20 for about since 1988 that's a confluence of many
21 deferred losses, deferred gains, all kinds of stuff
22 amortized into pension costs.

1 Lately, in the past year, we've had companies,
2 within the confines of GAAP, starting to use much
3 more stringent accounting on pension by getting rid
4 of deferred losses that they would otherwise
5 amortize. You have some companies that you have
6 the same audit opinion on both sets of pension
7 accounting principles used.

8 One is preferable to the other. There is
9 preferability letters for those companies that make
10 the changes, but you don't see that in the audit
11 opinion. It just says it's presented in conformity
12 with GAAP.

13 I think investors would like to know more
14 about the accounting principles being used, why
15 they're preferable, why they're doing a good job of
16 describing the economics of the firm. And I think
17 that's the kind of thing they'd really like -- that
18 investors would really like to see more of in an
19 AD&A than just near death events, or close calls,
20 whatever you want to call them.

21 So, that said, I just want to address one
22 theme that was recurring in some of the earlier

1 remarks about costs. Audits today are still a
2 bargain. In the last 5 years for the S&P 500, the
3 total change in the audit fee has been about 5
4 percent since 2006 through 2010. That's not much.

5 And in fact, there's in the S&P 500, there is
6 371 CEOs whose pay was greater than the entire
7 audit fee. So you can think what you like about
8 CEO pay, but it's making the audit fee look like a
9 relative bargain in terms of the work that's done
10 for the investor. I don't think I've ever heard
11 investors complain about the size of audit fees.

12 And I think if you give them something more in
13 the audit opinion with an AD&A or any of the other
14 avenues that we're going to explore today, I don't
15 think they'll complain about an increased fee
16 either. So I know that that sits well some folks
17 and not others, but the investors are the ones
18 ultimately footing the bill, and I don't think
19 they'd mind.

20 What else? That's all I've got for right now.

21 MR. BAUMANN: Thanks, Jack.

22 And let me turn to Mike Santay and then

1 Charles Elson and Kevin Reilly and then Florida
2 Rivera-Alsing.

3 MR. SANTAY: Thanks, Marty. And thanks, Jack,
4 for your comments on audit fees. We appreciate
5 that.

6 MR. CIESIELSKI: Thought you would.

7 MR. SANTAY: We understand investors are
8 seeking more information, and the auditors need to
9 bring more value, and we agree with that. We also
10 agree with the earlier comments that the auditor
11 should not be the original source of some of this
12 information that might be contemplated for the
13 AD&A. We don't think that's operational, as it's
14 currently positioned.

15 Whether the auditor is the asserter or the
16 attester, the end result should be the same. That
17 is, the information that's presented should be
18 accurate and useful in allowing the investor to
19 make their decisions in evaluating the financial
20 statements and the disclosures.

21 We believe that the auditor is in the best
22 position to be the asserter in this model, and it's

1 consistent with what their training has been and
2 what their role has historically been. To provide
3 subjective assumptions about the financial
4 statements in an AD&A we believe has a high risk of
5 calling into question the overall opinion that --
6 the GAAP opinion that they're providing.

7 We had analogized that to situations where the
8 auditor is faced with a qualification of their
9 opinion. You know, in those situations, the
10 auditor does become the asserter. They need to --
11 they have a requirement to disclose what management
12 has not in a qualified opinion. So, from that
13 perspective, the AD&A could be construed as
14 somewhat of a qualification of the auditor's
15 opinion on the financial statements.

16 Now it strikes me that what the key
17 disclosures are is what management -- what keeps
18 management up all night and why? And that should
19 be the basis for the financial statements and some
20 of the subjective analysis that we've been talking
21 about here.

22 And as it relates to opportunities for

1 improvement, I think we'll get into that in some of
2 the other areas as we talk through the day,
3 particularly auditor involvement in other
4 information. We talked about critical accounting
5 estimates. I think we'll talk a little bit about
6 some of the auditor involvement in perhaps interim
7 information and others, and I think that's going to
8 be important.

9 But I think providing the auditor specific
10 views as it relates to the subjective assessments
11 we think would be problematic.

12 Thank you.

13 MR. BAUMANN: Okay. Thank you, Mike.

14 Charles Elson?

15 MR. ELSON: I take just a slightly different
16 tact and look a little bit more at sort of the
17 governance implications of -- general governance
18 implications, I think, of the proposal. I mean, no
19 one can be against increased information and
20 transparency. That, in and of itself, is a good
21 goal. But I think sometimes you also have to look
22 at the side impacts of what you're attempting to

1 do.

2 What you've seen in the last 10 years since
3 Sarbanes-Oxley has been a tremendous change in the
4 nature of the audit committee. I mean, 20 years
5 ago, the audit committee was really the place you
6 put people who you really didn't know what else to
7 do with, and it was the worst place to end up.
8 Perhaps it still is.

9 But you've seen a real professionalization of
10 the committee itself, the idea of the financial
11 expert on the committee, the idea of financial
12 literacy on the committee. And it's really changed
13 dramatically. I mean, the notion that you have
14 retired auditors chairing committees is a new
15 concept and I think have been a very helpful
16 concept.

17 And the role of the committee itself has
18 changed in that the committee today engages the
19 auditor. Where 10, 15 years ago, it was management
20 who, effectively, hired the auditor, today, it's
21 the committee, and that was an important change in
22 SOX. So the idea of the auditor is to effectively

1 work for the committee, providing assurance to the
2 committee and the shareholders, obviously, of the
3 effectiveness of the financial reporting structure
4 and information that's being reported.

5 The difficulty, I think, with creating a new
6 auditor discussion and analysis section, which
7 basically reports on what the auditor thinks and
8 what the auditor has said or maybe hasn't said to
9 the committee, is it changes the nature of the
10 committee dramatically, if you think about.

11 Because what's happening now is the committee
12 engages the auditor, and the auditor is now being
13 asked to comment on all its relations to the
14 committee. It's like hiring a lawyer and having a
15 lawyer, after the lawyer advises you on what to do
16 and not to do, get up publicly and tell everyone
17 what they said to you and what they didn't say to
18 you, which effectively is substituting in a way the
19 auditor for the committee itself.

20 And that's a bit problematic. There's a
21 difference between advising a committee and giving
22 assurance to a committee and the shareholders and

1 effectively becoming the committee itself. And
2 from a governance perspective, I think if this goes
3 through as proposed and it begins to weaken the
4 committee -- it removes the committee as the middle
5 person, if you will, between the company and the
6 shareholders -- I think it ultimately may impact
7 negatively the monitoring role obviously that the
8 committee provides and the board itself.

9 Central to our system is the board within the
10 organization, representing the investors,
11 overseeing management for the benefit of the
12 investors. It's a small group who reviews
13 management for the benefit of the investors in the
14 company itself. And if you diminish their
15 authority and ability to monitor, I think you
16 really create long-term problems with the entire
17 board oversight model.

18 Substituting a third party, the auditor, for
19 the board itself, elected by the shareholders, in
20 this regard I think ultimately may lead to more
21 problems than not. It's the old "careful with what
22 you wish for, you may get your wish."

1 This is one of those because I think that
2 while greater disclosure is welcomed, the greater
3 disclosure here I think may lead ultimately to less
4 effective monitoring, which ultimately is more
5 harmful to the organization and the investors.

6 MR. BAUMANN: Thank you very much for those
7 very thoughtful comments.

8 Kevin Reilly, Florida Rivera-Alsing, and then
9 Paul Haaga.

10 MR. REILLY: Yes, Marty. Just let me make a
11 brief comment, and that is I just want to stress
12 one of the points that I view to be the 800-pound
13 gorilla in this debate. And that is -- and it's
14 the one that speaking for the profession through
15 the CAQ efforts is the one that has given us the
16 greatest amount of indigestion.

17 And that is the calls for the auditor to
18 provide subjective views and impressions
19 surrounding a company's financial reporting matters
20 is the one that we view to be really troubling in
21 this regard. And that is, look, we have these
22 conversations with audit committees. We provide

1 these discussions in due diligence reports.

2 But those communications happen, as Mike Cook
3 mentioned and as Bob Guido reiterated, in the
4 context of an effective, two-way discussion and
5 dialogue. And to blast this stuff out in a widely
6 distributed public report is going to be a real
7 problem and will create, in my view, significant
8 confusion for investors.

9 So, to Joe Carcello's question to the
10 profession, what's changed? I don't think anything
11 has changed, Joe. We are for change. We think it
12 has to happen, but it has to happen responsibly.

13 But to try to create a mechanism where we are
14 providing subjective views and conversations and
15 dialogues and impressions about a company's
16 financial reporting matters without the ability of
17 the audience to give and take with those
18 impressions is really not going to be constructive.

19 MR. BAUMANN: Although, as Joe said, he was
20 reading from a report of the GPPC, the partners of
21 the major firms, who said that in the future, we'll
22 be the ones to give insights and information

1 because we have it. I'm not quoting you correctly,
2 Joe, but it was something like that.

3 So I guess that's the question of it sounds
4 like there are some in the profession who think it
5 can be done and others are expressing this concern
6 about because it isn't a two-way dialogue, it's
7 going to be confusing, whereas the investors were
8 speaking up saying, "I don't think I'll be
9 confused. I want the information."

10 Any further thoughts on that or --

11 MR. REILLY: Well, Marty, I think, as was
12 articulated in the letter that we sent back in
13 June, I think there are ways that we can address
14 some of the demands from the investors, and we are
15 100 percent behind that effort. It's just in the
16 context of trying to convey and provide help and
17 assistance or views via our subjective impressions
18 is really not a healthy way to go in a format that
19 involves a wide distribution report.

20 I can tell you, and I've had the experience of
21 issuing a lot of due diligence reports throughout
22 the years, and I've got to tell you that the report

1 is issued. You then spend a day with the investor
2 group or the users of that report going back in
3 detail on "What do you mean by that?" "Provide
4 some additional perspective or context on that
5 finding." "What exactly am I supposed to do with
6 that?"

7 And that type of interchange will not exist in
8 the AD&A concept containing subjective views and
9 impressions.

10 MR. BAUMANN: Thanks, Kevin.

11 Florida?

12 MS. RIVERA-ALSING: Thank you.

13 First of all, thank you for the invite. And
14 second of all, my opinion that I am going to
15 express are my personal opinions and not of my
16 employer.

17 I support the AD&A. I believe that the
18 concern about having a boilerplate report moving
19 forward is something that we should have asked
20 ourselves like 20 years ago because in the past 40
21 to 50 years what we have been receiving is a
22 boilerplate opinion page.

1 The disclosures I'm looking for from the
2 auditors include what did you do to support the
3 opinion you issued? We have investment in the
4 private markets where the auditors will add an
5 emphasis paragraph saying that 85 percent of the
6 assets, the fair value of it is based on the
7 estimate of management. But there's nothing there
8 that tells me what did you do to be able to issue a
9 clean opinion of that financial statement.

10 I would also want to see what the auditor --
11 or to know what the auditors did to assess the risk
12 of fraud. That is not something that is disclosed
13 or discussed in the financial statements. I would
14 also want to see the corrected misstatements. What
15 about the uncorrected misstatements?

16 These are just some of the things I would like
17 to see. And I promise you and the audit firms that
18 are represented here that the additional
19 information you will provide to us will not confuse
20 me.

21 Thank you.

22 MR. BAUMANN: That's what I am hearing the

1 investors say. They won't be confused.

2 Paul Haaga, then I'm going to call on Sam
3 Ranzilla, Pete Nachtwey, Mark LaMonte, and Lynn
4 Turner.

5 MR. HAAGA: Okay. Thank you very much, Marty.
6 And thank you particularly for reaching out to and
7 including investors.

8 I think that if anybody has seen some of our
9 comments on various accounting issues, we've often
10 pointed out that investors are underrepresented, in
11 our view, on the boards that set these -- the
12 various groups that set these rules. And we're
13 delighted to be included here.

14 I don't want to be redundant. So I'll just
15 say that I agree with everything that's been said
16 and everything that's going to be said.

17 [Laughter.]

18 MR. HAAGA: As I said, we are a buy-side firm
19 that does deep research. We have many, hundreds of
20 analysts who use financial statements, but we also
21 issue hundreds of financial statements for our
22 mutual funds, like the gentleman from BlackRock.

1 And by the way, Jack, if you're taking a
2 survey, I would gladly trade my compensation for
3 all our audit fees.

4 But anyway, when I did the survey, I got the
5 information by survey, reaching out to both our
6 accounting staffs and our -- many of whom were
7 previously in private practice, and to our
8 analysts. And there was a lot of passion on both
9 sides, but the statement usually began, "This will
10 be great," or "This will be a disaster." And
11 everybody had a different "this" in mind. It was
12 sort of blind man touching the elephant.

13 Really, this release just asks a lot of
14 questions, and so I encouraged them not to focus on
15 this, but to turn around and work the other way and
16 say, "Okay, what can we do? What can we do better?
17 What would you recommend?"

18 There was a very strong consensus from
19 literally everyone, both sides, on the fact that we
20 can do better by investors. So doing something
21 would be our suggestion. I got a number of
22 examples from the analysts, and it always centered

1 around information that was uniquely known by the
2 auditors. So nobody wants to replace anybody's
3 role, substitute the auditors for management or
4 interfere with the audit committee role, but there
5 is some information known to auditors.

6 This should be modest, a modest cost for a
7 modest amount of disclosure, which causes me to
8 think that the emphasis paragraph is a better
9 vehicle than an AD&A because an AD&A is a separate
10 document, is likely to grow and be more
11 comprehensive and not be modest. So we would
12 prefer the emphasis paragraph.

13 I would suggest that the process here not be
14 to sort of work forward from grand concepts of
15 disclosure and matters that are to be commented
16 upon, but just work backwards and take a couple
17 examples. I don't want to fight the last war, but
18 I think we can learn from previous examples of
19 things that went wrong and say, okay, what would
20 the auditors have known? What could the auditors
21 have usefully pointed out without creating
22 liability, cost, or interference with

1 relationships?

2 And if we can identify that, then I think we
3 can write rules around that. And some of the
4 suggestions from my analyst colleagues about things
5 they would have liked to have known included
6 Chinese company structures and related party
7 transactions, Citigroup's CDO assessments,
8 Countrywide subprime loan securitizations, Lehman
9 repos, Fannie Mae derivatives, Freddie Mac deferred
10 tax assets, and AIG's credit default swap
11 valuations, just to name a few, and I'm sure there
12 are plenty more.

13 I also don't want to leave out something
14 that's been mentioned here. It's probably not a
15 mandate or specific role of the PCAOB, but we think
16 it's important, and that's strengthening the hand
17 of the auditors. The mere fact that there's more
18 to say than pass or fail, we think, would give --
19 and there was broad consensus on this -- we think
20 would give the auditors a stronger hand.

21 They would win more arguments, and we think
22 that would be a good thing. And that could be a

1 good thing even if they didn't say anything at all
2 in the emphasis paragraphs. Simply the ability to
3 say something there as an additional tool.

4 So thank you and, again, appreciate being
5 here.

6 MR. BAUMANN. Good. And thank you for those
7 very thoughtful comments.

8 Sam Ranzilla?

9 MR. RANZILLA: Thank you, Marty.

10 I guess where to begin? But I guess a day
11 that I get a compliment from Joe Carcello, maybe I
12 should just leave it at that.

13 [Laughter.]

14 MR. RANZILLA: But I'm not going to. As a
15 profession, we have looked at this issue for over a
16 year and read all the surveys. And I'm telling
17 you, I think the basic issue that I have had the
18 most difficulty in dealing with is, is that when
19 you boil this all down, at least in my view, this
20 comes as basically a situation where investors are
21 basically saying we don't trust audit committees.

22 And as a result, they're looking for the same

1 information that is provided to audit committees.
2 And I don't know that simply looking at the
3 auditor's report is going to deal with such a
4 fundamental issue as a lack of trust of what audit
5 committees are doing. So I'll leave that as sort
6 of an overriding comment that I'm not certain that
7 this Board can deal with this issue all on its own.

8 That said, when you get down to a different
9 level of the issue, the common theme is, as an
10 investor, I want to know more about those judgments
11 and estimates that are critical to the financial
12 statements and what is underlying them.

13 And you can slice that a number of different
14 ways, and I think Ann had a list or somebody had a
15 list of some things. And there might be some
16 things on the periphery of that, but it comes down
17 to most of what people are interested in financial
18 reporting is where are the estimates, and what is
19 the level of measurement uncertainty within those
20 estimates? That's what drives the volatility and
21 the ultimate reliability of a financial reporting.

22 So Marty tossed out for those that favor AD&A

1 how you overcome some of the downsides. I don't
2 favor AD&A, for all the reasons that others have
3 expressed that I won't go into today. But I would
4 like to address, and getting a little bit ahead of
5 myself, an alternative that simply does get to a
6 potential root of the issue without an auditor's
7 discussion and analysis.

8 And I refer you to the SEC financial reporting
9 codification on critical accounting estimates. And
10 I guess, Joe, this side of the room is going to do
11 some reading today, based on a remedial reading
12 class we had last night that you and I had to
13 attend.

14 But if you look at existing literature today
15 and what's required to be included in MD&A, the
16 concept of a critical accounting estimate is any
17 estimate or assumption is material due to the
18 levels of subjectivity and judgment necessary to
19 account for highly uncertain matters or the
20 susceptibility of those matters to change, and the
21 impact would be material.

22 If you fall into that category, this

1 particular reporting release asks the issuer to
2 respond to a series of questions, such as what
3 factors did you use in arriving at the estimate?
4 How accurate has that estimate been in the past?
5 How much has that estimate changed in the past?
6 And whether the estimate is reasonably likely to
7 change in the future and, if so, to provide some
8 form of sensitivity analysis because of the highly
9 uncertain nature.

10 Those are existing requirements. And as I've
11 looked at surveys, quite frankly, if that's what
12 you're asking the auditors, and I think that is a
13 major piece of the proposed AD&A, that information
14 is already required to be disclosed by issuers.

15 And one proposal would be for the auditors to
16 attest to those disclosures, not all of MD&A, just
17 a portion of MD&A to basically achieve two
18 objectives. One, improve those disclosures and the
19 compliance with those disclosures and, secondly, to
20 provide investors with greater confidence around
21 the disclosures around critical accounting
22 estimates.

1 So my point is, is that I, too, support
2 change. And I think there is a way to get to the
3 root of the issue if you can overcome the basic
4 lack of trust, which I don't think this Board can
5 do on its own.

6 But as a means to try to improve that
7 situation, there are superior alternatives, ones
8 which will allow management to provide information
9 and auditors to attest to it and allow us to
10 provide objective assessments of otherwise very
11 subjective information. And I think that that
12 particular alternative is superior to an AD&A.

13 Thanks.

14 MR. BAUMANN: Thanks, Sam.

15 And we're going to have a thorough discussion
16 later on, on the possibility of auditor reporting
17 on MD&A or parts thereof, such as critical
18 accounting estimates. Another way, Sam, of looking
19 at the point you just raised of a lack of trust
20 between investors and audit committees might be
21 maybe a lack of compliance with existing MD&A
22 requirements since they call for such information

1 about estimates, including sensitivity analyses as
2 to how these estimates were made and could change.

3 And I guess there's at least a question of
4 compliance if investors are saying we don't have
5 that information, and the rules are as specific as
6 I have in front of me and you've read. So we'll
7 explore that issue a little bit later.

8 Pete Nachtwey?

9 MR. NACHTWEY: Thanks, Marty.

10 And I'll just add my compliments to the group,
11 the Board and the others who have done so much of
12 what I think has been -- I know has been incredibly
13 hard work and, I think, very thoughtful work. And
14 it's clearly with the best interests of the
15 investment community in mind.

16 I'm going to state at the beginning I agree
17 with much of the direction that's being taken here
18 and the fact that the audit report is several
19 decades stale, if we want to refer to it that way.

20 But I also have some concerns just in terms of
21 unintended consequences and making sure that we're
22 thinking this through. And I, again, would add to

1 someone who said this earlier, compliment the
2 process and just continue to encourage you to keep
3 it open and very broad.

4 But I'd like to just state for the record, as
5 others have, I don't speak for my organization,
6 which currently is Legg Mason. But what I do speak
7 with is kind of what I think is a bit of a unique
8 perspective with wearing three hats. And while
9 I've had the honor of serving on the Investor
10 Advisory Group because I currently and have been
11 working with several large investment firms for the
12 last going on 5 years, I did spend 25 years in the
13 profession as an audit partner and in other
14 leadership roles.

15 Then the last 5 as an issuer and preparer of
16 financial statements, including for public
17 companies and, much like Steve mentioned, around
18 the world under various regulatory regimes. And
19 then, those CFO roles have kind of taken me into
20 the investment territory with two large global
21 investment firms that have about \$800 billion under
22 management of third-party money.

1 So, unlike my toughest critic is my wife, and
2 she usually thinks my opinions aren't very well
3 informed, I at least kind of feel I can bring a bit
4 of a 360-degree view of the issues that we're
5 talking about today.

6 So while I, again, agree with much of what's
7 being talked about, I do have specific concerns,
8 and they primarily relate to the first two topics.
9 So, again, I'll stick to the topic here, Marty, of
10 AD&A but stipulate that I have similar views around
11 the emphasis paragraph.

12 And first is just the cost benefit of doing
13 this. And as Mike said before, do no harm. We
14 need to understand that the costs that certainly
15 that I know we incur internally -- not just
16 externally, which is disclosed, but internally as
17 well -- to issue financial reports and comply with
18 what, again, are appropriate regulations, but we
19 need to recognize they're incredibly burdensome.
20 And the cost to comply is enormous, and that
21 ultimately is borne by our investors and our
22 shareholders.

1 Second concern is just the practicality. You
2 know, again, I think all of this is well meaning
3 and well intentioned, but the practicality of it, I
4 think we need to really be thoughtful about. And
5 the questions that I ask myself, particularly on
6 AD&A, are how would an auditor's AD&A differ from
7 management's, first and foremost? And then if it
8 doesn't differ, is the view worth the climb? I
9 mean, why would we do it if it's not significantly
10 different?

11 But then the catch-22 question, if it is
12 different, then I think most of the folks around
13 this table who are on audit committees or in audit
14 firms or, like me, are CFOs are going to spend an
15 enormous amount of time reconciling the
16 differences, which I think just leads us, at the
17 end of the day, to getting to boilerplate because
18 we simply don't have the time to do a lot of
19 creation of new work in the tight deadlines that we
20 have to operate under.

21 And then also if they are different, the
22 question is does that really help investors, or

1 does it cause them more confusion? Because they
2 then need to reconcile the differences, and they
3 won't be able to sit down, as others have said,
4 across from the auditors as the audit committee
5 could or other users of financial statements. I
6 also wonder how this again ends up being something
7 that's new information at the end of the day and
8 not just boilerplate.

9 So, lastly, just to provide a perspective,
10 because I've been asked to do that, and I'll try to
11 be very balanced. Hopefully, Joe recognizes that,
12 and I've worked with Joe on this. And again, I
13 compliment you and the rest of the committee that's
14 been working on it.

15 So I've spoken with many of the senior
16 investment people, not just the analysts, because
17 we've got a horde of analysts inside of Legg Mason,
18 a horde of deal people that are inside of Carlyle
19 where I previously served. And yes, they will
20 always say any additional piece of info -- you
21 know, even if it's on a scrap of paper I pick up
22 off the floor, it's like, you know, jeez, maybe

1 that gives me the one edge that I'm looking for to
2 look really smart to my boss.

3 But when I go talk to the guys that run our
4 funds and run our affiliates, and these are very,
5 very seasoned guys and gals who've been around for
6 decades, they're not clamoring for a change in the
7 auditor's report. It's, "Yes, it would be nice to
8 have."

9 What they're clamoring for, they'd love to get
10 more prospective financial information from
11 management, and that's a whole different topic we
12 won't explore today. And of course, the question
13 of should auditors be involved in that? But that's
14 what they like to have, what actually they would
15 say they must have is that prospective information.

16 They're always looking for what's around the
17 corner, not just what's historical. They do value
18 the audit opinion. They value reputable firms
19 being involved with issuer financial statements to
20 know that's solid base on which to build the rest
21 of the pyramid of how they're doing an analysis of
22 companies they're invested in.

1 So, at the end of the day, when I press them
2 on this issue, it's much more, "Well, okay, it
3 would be nice to have if we can get it, but it's
4 not a must have." And so, does that get over the
5 cost-benefit hurdle?

6 So I'd just say in summary, we need to be very
7 careful on how we're approaching this and be very
8 thoughtful. I'm not saying that, again, I'd be
9 against change, wearing any one of my three hats.
10 But just making sure we don't do any harm.

11 Thanks again for inviting me.

12 MR. BAUMANN: Thank you for coming and for
13 your comments, Pete.

14 Mark LaMonte?

15 MR. LAMONTE: Thank you. And thank you for
16 the opportunity to be here today.

17 Let me start with some of Peter's comments
18 because I found that very interesting in terms of
19 the value and the "nice to have" versus the "need
20 to have," and how investors and other users of
21 financial statements think about auditor reports
22 today and an audit.

1 I do think we find audits extremely valuable.

2 When we get a 10-K, there is an expectation that
3 those numbers have been audited, and we can place a
4 level of reliance on the accuracy and completeness
5 of the information that is very critical to the
6 decisions we're making.

7 The audit opinion itself holds very little
8 value to us in terms of what's written. This
9 concept that the numbers are audited certainly is
10 valuable. The opinion itself is essentially a
11 commodity. It really doesn't matter which firm is
12 auditing the numbers. As long as it's one of the
13 large, reputable firms, we're just happy the
14 numbers are audited.

15 So from the perspective of is the profession
16 delivering the greatest value, it certainly is
17 delivering a lot of value by providing us with
18 numbers that are audited, but it's not providing us
19 much insight above and beyond that. So I view this
20 as a nice opportunity to provide more.

21 Going to Pete's comments, is it something that
22 we're clamoring for? Not necessarily. Our

1 analysts get a set of financial statements today,
2 presume they're audited, and start doing their
3 work. Could the auditor give us something that
4 would be helpful to the work we're trying to do?
5 Absolutely.

6 I think the audit discussion and analysis
7 would be an opportunity to do that, would be an
8 opportunity for the firms to decommo­ditize their
9 product a bit and make it something that actually
10 has differentiated value amongst the firms.

11 Sam raised a very interesting idea about the
12 discussion of critical accounting policies. That
13 was a terrific idea when that was introduced, I
14 guess, what, 7, 8, 9 years ago now. It's become
15 largely boilerplate and another disclosure that's
16 largely ignored by investors today. It says the
17 same thing every year. It really doesn't say much
18 anymore.

19 Having an auditor provide that with their
20 objective view or participate in the delivery of
21 those three to five critical areas of judgment or
22 uncertainty that the investor needs to understand

1 to really make the best decisions with the
2 financial statements would be extremely valuable.

3 Having auditor views on those very difficult
4 decisions that come up or those areas where a
5 decision management has made could have been very
6 different would be valuable. Let me just use a
7 real-time example that would not be a U.S. example,
8 but might emphasize the importance of this should
9 we continue down the path and start incorporating
10 IFRS into our financial reporting.

11 When you were looking at second quarter
12 numbers for several European banks recently, you
13 saw wildly different outcomes for the numbers that
14 were being reported related to losses on holdings
15 in Greek sovereign paper, just wildly different.
16 Having auditor insight into how those ranges of
17 potential outcome were evaluated and where, to use
18 a golf analogy, a firm was hitting the ball in that
19 fairway of acceptable outcomes and how the
20 conclusion was supported and was okay I think could
21 be just incredibly valuable to investors as they
22 look at the numbers and think about how we want to

1 adjust or how we want to view the numbers
2 differently in our analysis.

3 It's always critically important to realize
4 that endless -- and investors are not just taking
5 what's reported. They're taking what's reported
6 and providing their own perspective on it. They're
7 making adjustments. They're making projections.
8 They're thinking about the numbers differently than
9 what's presented.

10 And having more insight into those from the
11 audit community, I think, with the objective view
12 of the audit committee could be very helpful to us.

13 And AD&A is one of those opportunities to do so.

14 Thank you.

15 MR. BAUMANN: So, Mark, as you spoke, you
16 sounded like you were a lot more supportive of the
17 AD&A because you talked about how valuable it would
18 be to understand how the judgments were made around
19 estimates that were so different from company to
20 company and as opposed to I think early on, I
21 thought you said it was a nice to have, but not
22 necessary?

1 MR. LAMONTE: I'm very supportive of it.
2 Could we live without it? Sure. If you want to
3 make an audit valuable beyond just having a
4 commoditized assurance over the numbers, then I
5 think it would be a terrific thing to have.

6 MR. BAUMANN: Okay. Thanks.

7 I've got Lynn Turner next, and then we'll call
8 on Steve Kozeracki, Alan Beller, and Wayne Kolins.

9 MR. TURNER: Thank you, Marty.

10 It's interesting to listen to this
11 conversation around the table. I've heard the
12 phrase "do no harm," "unintended consequences," and
13 "let's not get overly high on the cost." I can't
14 think of any other city in the country where I hear
15 those three phrases said more and yet, at the end
16 of the day, more damage is done to the investing
17 American public than any other place.

18 So I think those are all synonymous with just
19 saying "do nothing," which is pretty much what has
20 happened in this profession with this report since
21 this issue first really got a lot of attention
22 back, as Mike said, when he was on the Auditing

1 Standards Board. Unfortunately, at that point in
2 time, they pretty much did nothing and didn't do a
3 whole lot with the report.

4 It didn't change much. There were some
5 changes around the fringes, and so here we find
6 ourselves three to four decades later with the same
7 problem.

8 Rather than do no harm, I think, for once, the
9 Board ought to look at doing something that's
10 right, something that actually provides some value,
11 some information to the investing public. I don't
12 think the issue is raised because people don't
13 trust the audit committees. I think the issue is
14 raised because investors see reports like they've
15 seen at Lehman, at AIG, the judgments on the Greek
16 debt. And not only does the Greek debt look
17 impaired, it looks like the judgment of the
18 auditors has been impaired as much.

19 Adelpia, Xerox, you can go through it.
20 That's why people are asking for this information.

21 It isn't that they don't trust audit committees.
22 There may be a lack of trust. People don't trust

1 the auditors because they get that same clean
2 report from everyone, and yet, all of a sudden,
3 there is a blow-up and there was no red flags.

4 And when we get into the court cases, then all
5 of a sudden, in the court cases, we actually find
6 the auditors did know a lot. Some of it may have
7 been conveyed to the audit committee, but in a lot
8 of times, it isn't conveyed to the audit committee.

9 So that's what one court case after another
10 shows. And I think Paul had some very astute
11 comments in that the Board needs to go look at
12 those cases and take a look at what it was that the
13 auditor knew. What was their perspective on the
14 numbers that they never told the investors about
15 that would have been useful and helpful
16 information?

17 We are not looking for original information
18 from the companies. I agree with that. The
19 company has obligation to turn around and disclose
20 those. Those need to be improved. The CFA
21 Institute, others told us at the Treasury Committee
22 that those disclosures are deficit and need to be

1 improved, especially with respect to significant
2 judgments and estimates. That's the FASB's job.

3 But what we are looking for is the knowledge
4 that the auditor has and their perspective on the
5 information. That information that they have
6 should come from them. It shouldn't come from the
7 audit committee. It shouldn't come from
8 management. They're the independent body,
9 supposedly the independent body. Yet in so many of
10 these cases, you just wonder if they were ever
11 independent at all.

12 So that's what we're looking for is that
13 independent, unbiased perspective on some of those
14 significant things. I do think there is some value
15 to the standard report, but when we keep having
16 these blow-ups, you wonder if it's worth paying
17 for.

18 You know, you look at a Sino-Forest, where
19 someone, an individual outside could go look at
20 just publicly available information and find the
21 problem, but the auditors couldn't? And that with
22 an audit committee with three chartered accountants

1 on it, you know, it does raise a serious question.

2 So the auditors did have valuable information,
3 the court documents show, at Adelphia, at Xerox, at
4 Waste Management, at AIG, at Lehman, that I think,
5 unquestionably, any auditor doing basic,
6 fundamental research would have liked to have heard
7 and would have liked to have heard it from the
8 auditor.

9 I favor an AD&A. But at the end of the day, I
10 really don't care whether you put it in an AD&A or
11 an emphasis paragraph. I just want the
12 information. So whether you print it on page 13 or
13 print it on page 33 in the filing, I really don't
14 care, as much as I care about getting the basic,
15 fundamental information.

16 The concern with the use of an emphasis
17 paragraph is it does tag on to the current
18 paragraph, and it might be just easier if you just
19 give me the yes or no, pass/fail, and then give me
20 a separate report on what you think. I think that
21 actually will be easier for investors to deal with
22 and read and comprehend.

1 The other concern with the emphasis paragraph
2 is if you make it optional at all, then I'll
3 guarantee you, you will do harm because you will
4 have not done anything. Because the profession has
5 been able to use emphasis paragraphs for two, three
6 decades now and just never use them. Just never
7 use them. So this is not something that can be
8 made optional.

9 In regards, as far as boilerplate, I think
10 that's something certainly to be looked at. I
11 think Paul's notion of maybe field testing a little
12 bit here would be helpful in that respect. But we
13 do have MD&As that are very specific to each
14 company, and they are able to do MD&As. And what
15 you're telling me here is the audit partners in
16 these firms are so undertalented that they can't do
17 what the company is doing.

18 The company seems to be able to write that
19 MD&A. Gary and Larry and others turn around and
20 work on that MD&A. Larry was an audit partner, but
21 you're telling me, as an audit partner, he couldn't
22 write that type of specific company information? I

1 don't buy it. I think these are very talented
2 partners. I think they're very up to it.

3 The difference is you've got to pull the
4 attorneys out of it. The audit committee reports
5 have become -- despite encouragement from the SEC
6 not to do it, the audit committee reports have
7 basically been turned over to the attorneys and,
8 viola, of course, we're going to get something
9 boilerplate out of the legal profession. It's what
10 they do.

11 So I think you'd want to do something to make
12 sure that you don't end up with that, that you do
13 end up with something specific, like MD&A, which
14 you can already do.

15 As far as timing, I think Mr. Kueppers raised
16 the question about timing. In each of these
17 audits, at the end of the audit before we sign off
18 on the audit report, before the partner signs off,
19 they have to write -- it's mandated by the PCAOB's
20 own standards -- a completion memo. And if there
21 is one thing that investors ever would want to see,
22 it would be that completion memo because that

1 completion memo is your own standards highlight,
2 tells you you've got to discuss what the big ticket
3 risks were, what the significant items were, and
4 your perspective on those.

5 That is unequivocally, anyone that's written
6 those, anyone that's seen those would know that's
7 the one thing that investors would really like to -
8 - all you have to do is take those on some of these
9 audits and put it out there publicly and ask
10 investors if they'd like to see it. I guarantee
11 you, they would love to see those memos.

12 So by the time you get down to writing --
13 signing off and writing the report, you'd already
14 have some of this drafted because you have to do it
15 as part of the audit. To say that you couldn't
16 write this is incredible because you already have
17 to have written it before you signed off on the
18 audit report. And so, now it's just taking and
19 dropping that down into the right type of language
20 and something that is plain English that the
21 investors could understand, and I see no reason why
22 these talented partners couldn't do that.

1 I think investors have been very succinct in
2 what they've been asking for. In fact, in their
3 2006 white papers, the CEOs of these exact large
4 firms turned around and said users of financial
5 information may demand from public companies the
6 ability to receive more finely nuanced opinions
7 from auditors about the degree of a company's
8 compliance with a given set of standards or the
9 relative conservatism of judgments compared to peer
10 groups, or more boldly, investors even may want an
11 auditor's view about the overall health and future
12 prospects of the company they audit.

13 The CEOs, as Joe aptly noted out before, the
14 very CEOs of these firms, the guys running these
15 firms, have said investors are looking for this
16 type of information. And to the extent we can get
17 information that will enhance the performance in
18 our portfolio because we've done a better job of
19 allocation, we're more than willing to pay that
20 cost because we get tremendous benefit back from
21 it. That's the real benefit.

22 I can guarantee anyone had had the information

1 that the auditors did on Adelpia, on a Xerox, on
2 an AIG, on a Lehman, would undoubtedly have
3 significantly enhanced their performance, and the
4 cost would be a drop in the bucket compared to what
5 it did to the returns on those entities.

6 As far as the auditors reporting on critical
7 accounting policies, I've recently had the chance
8 to go back and look at some critical accounting
9 policy disclosure by companies. And quite frankly,
10 there is not a whole lot more in those than what
11 you already get in the footnotes.

12 They probably, in a lot of cases, don't comply
13 with what the SEC was looking for in terms of the
14 robustness. So I understand the benefit of getting
15 something that says they've got in there what they
16 need. But I don't see that as a performance
17 enhancer to me as an investor.

18 If you want to have the auditor's report on
19 the entire MD&A, I can see that. But there is
20 legitimate arguments that we ought to make sure the
21 auditors get the entire audit done on the
22 financials right first before we go on to MD&A, and

1 I would probably share that view.

2 I'd like to see MD&A, but I'd like to get the
3 financials right first. But just expanding it to
4 critical accounting policies, I see absolutely
5 zero, no benefit to that in terms of enhancing the
6 performance of our portfolios where we need it.

7 So, with that, I think that's it, Marty.

8 MR. BAUMANN: Thanks, Lynn.

9 On your comment regarding emphasis paragraphs,
10 the concept that was in the release dealt with a
11 required and expanded use of emphasis paragraphs.
12 So I do acknowledge that they're used very
13 infrequently today, but if it were an alternative
14 or at least the one presented in the concept
15 release is one in which there would be standards
16 written by us, which would require emphasis
17 paragraphs in certain cases.

18 So, hopefully, that would at least improve
19 that scenario. And as you said, you don't care if
20 you get it from that way or from an AD&A, you want
21 to get pointed to where the critical information is
22 in the financial statements.

1 MR. TURNER: What I want, actually, I want the
2 critical information that the auditor knows about
3 what the company has already disclosed. I agree
4 with the statements that the basic information
5 about the company should come from management. The
6 audit report is already required to disclose if
7 information isn't there that should be there, and
8 hopefully, they would uphold that standard.

9 But I want to know the auditor's perspective
10 about the things like what we saw with the
11 valuations at AIG, the Repo 105 transactions. You
12 know, the Greek debt thing was just an abomination,
13 to say the least. The Xerox, the Adelphia. The
14 auditors in each of those cases, the court cases
15 have shown new, very significant information that
16 was very vital to the investors, and they didn't
17 say anything about it.

18 And when that occurs, that's when, and very
19 rightfully so, investors lose trust and faith in
20 the auditors. And that's what needs to be fixed.
21 And you talk about the emphasis paragraph. I guess
22 my real concern, Marty, is you'll do incremental

1 change. You'll tweak with the regular opinion
2 some, and then you'll do a tweak on the emphasis
3 paragraph.

4 If all we do here is incremental change,
5 people will be -- different people will be in this
6 room three to four decades from now, just as we're
7 here three to four decades after the Cohen
8 Commission report, and we'll be having the same
9 debate/discussion again. I know that's pretty
10 common in this city, but that ain't how to fix
11 problems.

12 And if you want to just say we'll do no harm,
13 that's where you're going to be. If you want to
14 say let's go do something that's right, then you
15 aren't going to have incremental change.

16 MR. BAUMANN: Thanks, Lynn.

17 Stephen?

18 MR. KOZERACKI: Thanks very much for this
19 forum, and I do echo a lot of Lynn's comments and
20 do think that and Vanguard believes that an AD&A
21 would be very useful. And it's very important to
22 get a better understanding of some of the judgments

1 and assumptions that are made and how the auditors
2 basically -- especially for some of the big issues,
3 how the auditors got themselves comfortable with
4 that.

5 And there may be some issues, we're dealing
6 now with some of the liability for mortgage
7 putbacks on financial institutions, and maybe those
8 would be very tough for them to get comfortable
9 with. But maybe they need to -- it would be
10 important for them to highlight those that would be
11 very difficult, and what are the big issues and
12 what judgments were made. And like I said, how
13 they got comfortable with it.

14 So, as I said, we're very comfortable as a
15 firm and think investors deserve more, and the AD&A
16 would be very helpful and an emphasis paragraph
17 would be helpful as well.

18 The rest are sort of my just personal
19 comments, and some of this is from listening to
20 people speak. I've never attended an audit
21 committee meeting, but I've heard numerous times
22 from some of the preparers and the auditors about a

1 two-way dialogue and a three-way dialogue and how
2 difficult that would be to capture in an AD&A.

3 And, but just listening to it, it sounds like
4 it's being approached by the parties involved as
5 more some sort of negotiation, as opposed to, you
6 know, are they going in there saying, "The audit
7 committee want a clean opinion, the auditors want a
8 clean opinion, and the company wants a clean
9 opinion. And what's it going to take? And what
10 are we going to talk about, and who's going to give
11 what, and how do we all get comfortable with it?"

12 And that just doesn't feel like that's the way
13 to be approaching this, if that is what happens.
14 If the approach is more of how are we going to get
15 the most accurate financial statements and how are
16 we going to get the most appropriate information to
17 investors, it seems like the parties would be
18 coming and the discussion would be very different.

19 And it wouldn't be a negotiation. It would be
20 more about getting it right.

21 Another comment that came up several times,
22 this talk of close calls. Close calls sort of goes

1 back to this idea that the audit committee meetings
2 have turned into negotiations. If the AD&A is
3 there and it's present, maybe close calls go away.

4 Maybe then people say this could get brought up in
5 the AD&A. The auditor may disagree on it. It may
6 be disclosed.

7 So maybe we're going to take a more
8 conservative approach now, and then now you don't
9 have the close calls. And maybe those stop, and
10 maybe those should be stopped.

11 We've heard a lot also about that it's the
12 responsibility of management on disclosure. But
13 certainly in the financial institution area, we
14 find disclosure is especially inadequate. Going
15 back to one of the large institutions that failed,
16 you can read in their footnotes about owning \$40
17 billion plus in mortgage-backed securities, the
18 average credit quality of which was AAA. Well, I
19 guess that was an accurate statement, but it
20 clearly, you know, was not adequate and in
21 hindsight clearly not appropriate.

22 I think we found a lot of times also with

1 financial institutions, management only provides
2 the disclosure and the insight and their thought
3 process and judgment when their stock drops
4 dramatically or their bond spreads widen. It's
5 certainly not something that they've shown in
6 history that it's something they do, that they're
7 forthcoming about unless it's actually being
8 reflected in the pricing of their securities in the
9 capital markets.

10 Another comment was also made about the MD&A
11 and the AD&A could be very different. Maybe they
12 could be different, but maybe that would be just
13 for a period of time of a year or two where some of
14 these differences need to be worked through. And
15 when people start seeing that there are
16 differences, then it would raise some questions
17 about what management is doing, how they're
18 reporting things, what their estimates are, and why
19 is there a big difference with the auditor
20 assessment of those?

21 Like I said, there may be this transition
22 period. There may be a period of time where it

1 would be tough to work through. But once you got
2 through that, you might actually get much better
3 behavior and much more accurate reporting from the
4 issuers.

5 Just finally mentioning again, we're dealing
6 with it right now, people were mentioning the
7 sovereign debt issues, what's going on in the
8 mortgage markets. These are issues that are
9 impacting investors. We have seen market values
10 across markets dropping tens of billions, hundreds
11 of billions, in some cases with major selloffs,
12 trillions of dollars.

13 Investors, who are ultimately the ones paying
14 for the auditor's opinions, I think would be well
15 served with more disclosure certainly on the big
16 issues. And I think having the AD&A there, I said,
17 we might see better behavior from management and
18 more conservative reporting in general.

19 MR. BAUMANN: Stephen, thanks for those very
20 thoughtful comments.

21 I'm going to turn to Alan Beller.

22 MR. BELLER: Marty, thanks very much and thank

1 you for allowing me to participate today.

2 A couple of basic principles. Just my
3 perspective on this. I was at the SEC when some of
4 those rules, which we all would like to work
5 better, were put into place, and some of them
6 should work better.

7 I'm currently a partner at a Wall Street law
8 firm. I do sit on an audit committee of a Dow
9 Jones company, and so that's where I'm coming from.

10 I'd like to avoid not only unintended
11 consequences, but intended consequences that are
12 unfortunate. I am in favor of changing the
13 pass/fail model. Don't get me wrong. I think
14 there's value in the pass/fail model. We're all
15 prisoners of our past, and I don't want to sit
16 through Enron again. I don't want to sit through
17 WorldCom again, and I don't want to sit through
18 Tyco again.

19 But there is no question but that the
20 regulators in the profession and the preparers can
21 do better by investors. And there is no question
22 but that investors are demanding that they do

1 better.

2 Having said that, AD&A is as -- AD&A, I think,
3 probably means something different to everybody
4 around this table. But at least the way I'm
5 hearing it, which is a fairly broad-gauged attempt
6 by auditors to describe in their own words what
7 they see about the company as a result of the audit
8 process, I do not favor.

9 Lynn should not underestimate the ability of
10 my profession to turn that into boilerplate.

11 [Laughter.]

12 MR. BELLER: It will become boilerplate. It
13 actually will be less productive than some of the
14 more modest targeted suggestions that have been
15 made around the table.

16 Paul Haaga said let's be modest. I absolutely
17 agree with him about that. I think there are some
18 meaningful improvements that can be made in terms
19 of asking auditors to tell investors more about the
20 things they really know about that could help the
21 process.

22 Is that a mini AD&A? Is that required

1 emphasis paragraphs? I'm not really sure I know,
2 and frankly, like Lynn, I'm not really sure I care.

3 But let's take an example that's been talked about
4 a lot and just focus it on critical accounting
5 estimates. That's actually a two-part exercise.

6 Sam and Marty both have in front of them the
7 accounting release that was issued January '02?

8 MR. RANZILLA: Close.

9 MR. BELLER: December '01? There's been a lot
10 of work done at the SEC since then, and there
11 hasn't been any further codification. You really
12 want better disclosure rules around critical
13 accounting estimates, and you want better auditing
14 standards around critical estimates. And I think
15 if you did those two things, you would really be
16 doing investors a service if you then said let's
17 have the auditors tell us what they did to provide
18 better assurance around those numbers and the
19 identification of those estimates than you're
20 getting today would be a huge win.

21 And Lynn, we might be here 30 years from now
22 debating what else to do. But if you could promise

1 me that at the end of today, I would be very happy.

2 And I think investors would at least think they've
3 gotten something out of the bargain.

4 Same issue around uncertainties and accruals
5 and actuarial information and reserves. Some of
6 those, the standards are actually not too bad. But
7 some of them the standards really aren't very good.

8 In almost all cases, the auditing standards could
9 be sharpened, and you could accompany that with
10 better disclosure. And if you did those couple of
11 things, I really think you'd be on the right track.

12 Asking auditors to kind of go through the
13 other information that management discloses, you
14 want auditors to second-guess what the company
15 thinks the competition is going to do? I don't.
16 Do you want the auditors to second-guess what
17 inflation rates are going to be in 2012 and '13? I
18 don't particularly. So I'd leave that on the
19 cutting room floor and take what I could
20 constructively get.

21 Close calls is, I think, a little tricky
22 because what some think of as close calls -- close

1 calls. If by close calls, you mean what do people
2 on audit committees spend a lot of time thinking
3 about, those are not necessarily the close calls in
4 the sense that management wants to pull one way and
5 the auditors want to pull the other way. Those are
6 the really super important numbers in somebody's
7 financial statements, and they are going to get
8 more attention at a well-run audit committee. And
9 they are going to get more attention in a well-run
10 company-auditor relationship, but they are not
11 necessarily close calls.

12 And if we start focusing disclosure on "close
13 calls," the issues where auditors and companies
14 push and pull the most, I think you may be shooting
15 at the wrong targets. And so, I don't really think
16 close calls is where you want to go.

17 Disagreements. A lot of what we've heard
18 around the table, I think is, and somebody said it
19 earlier on, but it's implicit in a lot of what we
20 heard -- especially I think what we just heard --
21 some of these kinds of disclosure requirements will
22 provide auditors more leverage over management. At

1 the end of the day, company disclosure will change.

2 And indeed, company disclosure might change for
3 the better.

4 And indeed, that's one of the reasons I kind
5 of like the idea of pushing auditor disclosure
6 around estimates and uncertainties. I think your
7 MD&A disclosure on those subjects will get better
8 over time.

9 But the flip side of that is what has been
10 going on since Sarbanes-Oxley really is, in the
11 majority of cases, I think, certainly the majority
12 of cases I've seen -- I've seen dysfunctional
13 boards. I've seen functional boards. In the
14 majority of cases I've seen, you've really got
15 audit committees trying to do the right thing
16 already, and giving the auditors the ability to
17 push audit committees in a particular direction,
18 the upside is the auditors may get what they want.

19 And I'm assuming that would be good for investors.

20 The downside is that auditors might get less
21 information than they're getting now. And I think
22 you have to be -- you have to be careful about

1 that. You have to be careful about that dynamic.

2 But there are some really constructive things
3 that can be done within the four corners of this
4 concept release, and I hope that the Board
5 continues on its very thoughtful course and gets us
6 there.

7 MR. BAUMANN: We're getting lots of thoughtful
8 comments to help get us there. Not along the same
9 track, but a lot of helpful, thoughtful comments to
10 help get us there.

11 December 2003, the release.

12 MR. BELLER: Oh, that's my -- I wrote that
13 release.

14 [Laughter.]

15 MR. BAUMANN: It is. It's brilliant. I agree
16 with that.

17 We have Wayne Kolins, Larry Salva. Then we
18 better go to Professor Cox before the rest of his
19 table collapses over there. So I want to get you
20 before something else happens.

21 MR. KOLINS: Yes, thank you, Marty.

22 I'll be brief because many of the comments I

1 was going to make, almost all of them, were just
2 made, just 3 minutes ago by Alan Beller.

3 It's clear that the reporting model has to
4 change, and in my view, the changes have to be
5 meaningful, and they have to be practical. And I
6 think the better approach to go in that direction
7 is through looking at the alternates of the
8 critical accounting estimates and the mandated
9 emphasis of a matter paragraph. And I think much
10 of what is in there could go a long way to
11 fulfilling the investor needs for information about
12 the sensitive areas of the financial statements.

13 It was also mentioned earlier on as an example
14 of the kind of information, the information in a
15 due diligent report. But it was mentioned
16 subsequent to that initial mention of it was that
17 the due diligent reports are subject to a
18 significant amount of two-way dialogue in a very
19 granular fashion and not the type of negotiation
20 that was earlier described as possibly a way to
21 describe what happens in a discussion at an audit
22 committee level.

1 Those kinds of discussions are very granular.
2 They're really to get an understanding of what the
3 issues are and not to negotiate the issue, but to
4 make sure all of the facts are considered and the
5 best decision is arrived at.

6 Thank you.

7 MR. BAUMANN: Thanks, Wayne. Larry?

8 By the way, we're running a little bit over
9 the schedule that was on the agenda. But the AD&A
10 I think is one of the most important subjects and,
11 clearly, one of the most critical topics we want to
12 get input on. So I am going to try to get each of
13 these cards that are still up, and we'll just cut
14 into a little bit of what we cover in the
15 afternoon.

16 But I think this is clearly a critical aspect
17 of the meeting. So bear with me, and lunch will be
18 about probably just 30 minutes later than was on
19 the schedule.

20 Larry and then Jim, Professor.

21 MR. SALVA: Yes, thanks, Marty.

22 And to try to achieve that or facilitate

1 achieving that objective, I'll also be brief
2 because I guess the benefit of being late in the
3 lineup is many of the comments that I would have
4 otherwise made have been made by other
5 participants.

6 But I do want to at least anchor mine in some
7 of those prior comments, and that was the
8 observation that it's been 10 years or less that
9 we've had the SRO mandate of audit committees
10 including financial experts and people with
11 financial literacy.

12 And the other comment, that the idea of the
13 governance structure that we have of the audit
14 committee actually operating on behalf of the
15 shareholders and investors and users of the
16 financial statements. And so, the financial
17 literacy and financial experts, at least my
18 experience, I think that it was geared more mostly
19 toward accounting knowledge, financial knowledge of
20 accounting matters. It does extend into audit
21 matters when necessary.

22 But I question whether, as Gary said earlier,

1 the ordinary investor, who is the ordinary
2 investor? And I think a lot of the calls for
3 increased information is coming from investors that
4 do maintain a fair level of financial literacy and,
5 in some cases, may actually run to audit literacy
6 besides just accounting literacy and accounting
7 expertise.

8 So my concern, especially with an AD&A, if it
9 were to get into areas of specific audit procedures
10 and specific findings, I believe will serve to
11 confuse rather than inform the "ordinary investor."

12 It may help sophisticated investors that have
13 audit knowledge and detailed accounting knowledge.

14 But I'm concerned that it may, in fact, widen the
15 expectation gap rather than serve to close it.

16 So Sam made the point before about the
17 fundamental concern here may be that there's a
18 distrust of either management or maybe it's
19 certainly management, because if you don't trust
20 the audit committee to do what it's supposed to do,
21 then there must be a distrust of management doing
22 what it's supposed to do, which is prepare accurate

1 and timely financial information for the market.

2 I'm in favor of more modest change. I do
3 absolutely believe that change -- that improvements
4 can be made, but I believe the changes ought to be
5 more modest, as have been suggested by some other
6 commentators, and that they should be focused more
7 on what appear to be the areas that were the
8 concerns in like the critical accounting judgments
9 and estimates.

10 Some of the companies that have been mentioned
11 clearly were either business failures and/or audit
12 failures. But the majority of what goes on in
13 public reporting are neither of those. And I'm
14 kind of against writing rules to try to prevent
15 that 1 or 2 percent of kind of the bad reporting
16 that occurs or the audit failure that occurs. It's
17 going to burden a system that is, I believe,
18 already burdened significantly in terms of time and
19 cost.

20 I absolutely believe that audits have value,
21 and I might even believe that -- and this is where
22 I shouldn't get quoted -- that maybe they are cheap

1 in comparison to some other things that companies
2 pay for, especially legal fees, which I don't see
3 negotiated quite the same way that audit rate per
4 hour fees are negotiated.

5 But they add tremendous value. But to the
6 average investor, it's very valuable, I believe, to
7 have a pass/fail opinion. It can be supplemented
8 and should be supplemented, as is suggested in the
9 financial reporting or the codification. But I
10 also believe that if you read those specifics, they
11 are rarely complied with by registrants in terms of
12 getting into ranges of estimates or sensitivities
13 or what-ifs in the critical accounting judgments
14 and estimates.

15 That would be a major improvement, I think, if
16 auditors were involved in looking at that and
17 required to report on it potentially in an emphasis
18 paragraph.

19 MR. BAUMANN: Thanks, Larry.

20 Professor Cox?

21 MR. COX: I'm going to hang on to my
22 microphone because I'm not sure Mark isn't going to

1 stretch his legs one more time here. So I'll grab
2 it.

3 I want to just echo the point that was made by
4 a couple others. One, whatever we do, we should
5 probably identify just particular areas. And
6 whether that's going to be in the AD&A or emphasis
7 paragraph may depend on the item, but I don't think
8 it really matters at the end of the day.

9 But one item I was going to emphasize was
10 something that Jack and Paul had mentioned earlier,
11 and that is I think there is a lot of information,
12 at least on the audit committees I've been on,
13 where -- that's imparted where the auditor comes in
14 and says this is the normal area of reporting on
15 the audit risk. But in this environment we're in,
16 we have a new one.

17 You can think about relational transactions.
18 You can think about acquisitions that were carried
19 out. You can think about volatility, and I think
20 that, in and of itself, has a good deal of
21 information associated with if it's shared with
22 investors. And I don't think you have to go the

1 next step and identify to investors the procedures
2 that are going to be used necessarily to go at
3 that. But I defer to others on that, but I think
4 that just identifying those risks are enough.

5 And then I wanted to relate that to something
6 that Stephen had mentioned earlier, and that is how
7 the impact of disclosure on managerial and
8 oversight decision-making, and that's from some
9 personal experience. And that is I had the great
10 professional pleasure of overseeing the
11 investigation, internal investigation of the
12 largest financial fraud that was carried out in the
13 1990s.

14 And one thing that was going on there, much to
15 my surprise, was known by the auditors and known by
16 the audit committee, each of the members of whom I
17 investigated, but never shared with the investing
18 public. And that is the fact that they had carried
19 out a number of acquisitions in which the reporting
20 systems were not compatible, and it enabled this
21 company in a very short period of time, which had a
22 global network of over 30,000 employees, to make

1 sure that one out of every four paychecks that were
2 sent out -- not just once, but repeatedly -- were
3 the wrong paychecks for the wrong amounts. Okay,
4 that's how bad the accounting system was.

5 And I always wondered that if there had been
6 disclosure of the risks, which were identified by
7 what was then a "big five" accounting firm going
8 forward, whether that would have changed a lot of
9 the behavior in the organization. I don't know.
10 That's a jump ball.

11 But I can certainly say that individuals
12 buying this Fortune 100 firm would have thought
13 about it a lot differently if the information that
14 was within the audit committee and in the
15 accounting suites of that firm was made public.

16 MR. BAUMANN: Thank you.

17 We have Chris Spahr.

18 MR. SPAHR: Hi. Thank you.

19 I've been covering U.S. financial companies
20 for over 10 years with Mike Mayo. We've had many
21 public battles on accounting issues with some of
22 the largest global financial firms. Not once have

1 we looked at an audit report. We don't find them
2 very helpful. We do appreciate the audit process
3 and the stamp of approval of pass/fail, but we
4 don't find the audit report itself as a useful tool
5 whatsoever.

6 So we endorse what Lynn recommends with the
7 AD&A, and I have some more specific suggestions
8 I'll have for later panels.

9 Thank you.

10 MR. BAUMANN: Thank you.

11 Mike Gallagher, Doug Bennett, Joan Waggoner,
12 and Mary Hartman Morris gets the final word.

13 MR. GALLAGHER: Thanks, Marty.

14 I want to thank Joe Carcello first. Out of
15 all the quotes he might have chosen, he chose two
16 PWC chairmen. So, Joe, thanks for that.

17 [Laughter.]

18 MR. GALLAGHER: In all seriousness, I think
19 the comments of Sam and Dennis really demonstrate
20 the mindset of the profession in wanting to be
21 constructive, and I think that we clearly have an
22 interest in doing that, and it gets to the

1 relevance of what we do in the capital markets.

2 And so, I think that quote and that comment could
3 have come from any of the firms because I think
4 that's the spirit with which we got into this
5 dialogue.

6 I also think it's the spirit with which we
7 responded in the June 28th response to Marty and
8 team, and I'll echo the compliments of a very
9 thoughtful process. We, as a profession, have been
10 thinking about this and working pretty hard over
11 the last year.

12 And again, the spirit with which we provided
13 those comments were we realized that change needed
14 to happen. We need, in order to be relevant, to
15 better accommodate the needs of our ultimate users.

16 And at the same time, it's got to be with the
17 appropriate balance, looking at the end game, not
18 just good intentions in terms of what might be good
19 and what people are asking for necessarily.

20 Without looking through the lens based on what
21 we know about what happens on the ground in terms
22 of practicality. You know, what are the issues,

1 and how can we do it? How can we move the ball in
2 a positive direction without potentially doing
3 damage? All good intentions aside.

4 So that was the spirit with which we provided
5 our comments. We are learning. We continue to
6 learn. I think the dialogue we're having today
7 will continue to inform our views as they evolve.
8 I think it's been a good dialogue.

9 I won't reiterate all the reasons why I
10 believe the alternatives that we put forward are
11 better than auditor discussion and analysis. I
12 think Sam hit a few of them. I think Bob Guido's
13 point about diverting effort towards as opposed to
14 spending the time on meaningful auditing I think
15 are a couple that really resonate with me.

16 Speaking of audit committees, I guess I would
17 challenge the notion that an audit committee is a
18 negotiation. I've been involved in a lot of audit
19 committee meetings over the years, and I never
20 viewed any of them as a negotiation. It's a great
21 dialogue. It's a great discussion.

22 The audit committees have the responsibility

1 for overseeing financial reporting. I think the
2 quality of audit committee performance over the
3 last -- since Sarbanes-Oxley has improved
4 dramatically. Now that we have independent
5 directors, I think they take their roles very
6 seriously.

7 And I also agree with the point that some are
8 certainly better than others. But the quality has
9 improved dramatically, and I think undermining
10 audit committees is a danger here and is part of
11 the ways that we might do damage if we're not
12 careful.

13 And if you look at what we've discussed with
14 audit committee, there are very substantive issues
15 around the quality of financial reporting,
16 recognizing that in many cases there are
17 alternatives, not necessarily one being better than
18 the other. Many cases, you have multiple
19 alternatives that two people could have very
20 different views around preferability. And those
21 are good discussions with audit committees.

22 And the last part about audit committees is

1 one of the most valuable pieces of the audit
2 committee in my mind, audit committee meetings, is
3 the private session, where an auditor can have that
4 discussion with the audit committee without
5 management and have a real candid dialogue around
6 what we think and hopefully informing the audit
7 committee's mindset in terms of carrying out their
8 responsibilities for oversight.

9 So, again, I appreciate debate. I think this
10 is a great -- for the profession, this is a great
11 thing. The fact that we're talking about the value
12 that we can bring to the market. I appreciate
13 Ann's comments acknowledging the value that can
14 come out of the audit.

15 We will continue to look for ways that we can
16 better meet the needs of investors and do it in a
17 way that, hopefully, is balanced and really does
18 achieve the outcome.

19 So thanks, Marty.

20 MR. BAUMANN: Thanks. And we appreciated very
21 much the receipt of the letter that you worked on
22 so hard, and others in the profession, from the CAQ

1 that not everybody in this room would agree with
2 your position on the AD&A, but the thoughtfulness
3 of the letter and the timeliness of putting that
4 out there as a strawman was very helpful, I think,
5 for us. So we appreciate your participation in
6 that.

7 I think I said Doug and Joan.

8 MR. BENNETT: Thank you, Marty.

9 And I'll be brief because many, if not most of
10 the comments that I would make have already been
11 made by my colleagues previously.

12 But I wanted to emphasize one or two of the
13 points that have been touched on earlier and put
14 this in the context of what troubles me most about
15 AD&A. And that is the notion that -- and I
16 certainly appreciate the fact that investors are
17 looking for additional information. Auditors have
18 information, and is there a way that that can be
19 communicated so that it's meaningful and helpful to
20 investors?

21 I think that there are ways to do that, and as
22 many have pointed out, I think we'll get to those

1 this afternoon. But in the context of an AD&A,
2 I've heard discussion and a desire to just tell us
3 how you get comfortable with those difficult
4 estimates or those numbers that are the riskiest
5 elements of the audit.

6 And one notion was that, well, we as auditors
7 have to compose and draft an end of engagement
8 completion document, which we do. And just give us
9 that information and put it in a form and context
10 that the investor could understand.

11 And I would find that extremely difficult to
12 try to communicate what my audit team, as skilled
13 professionals, trained professionals with years of
14 experience and training, and try to condense that
15 and communicate that in a document to investors
16 that don't have -- and the comment has been made
17 that there is a two-way communication and
18 opportunities with audit committees to have that
19 communication.

20 But without that ability to have some back and
21 forth discussion and explain what was done, what
22 the auditor views were, I think, it would, in my

1 view, be nearly impossible to condense that into a
2 document that could be made a public document.

3 Thank you.

4 MR. BAUMANN: Thank you. Joan?

5 MS. WAGGONER: Well, again, thanks, Marty, for
6 the invitation today.

7 My firm has a practice in smaller issuers. I
8 have been listening with great interest to the
9 comments today and again will try not to duplicate
10 other comments that have been said that I agree
11 with.

12 But one of the things that has occurred to me
13 as I've listened today is I've heard how important
14 to investors are the unbiased viewpoints of the
15 auditors. And one of the things that I worry
16 about, should we move to a model of reporting that
17 allows auditors' views to be introduced such as
18 AD&A, that we would be introducing perhaps an
19 element of bias.

20 And it would seem to me that in the financial
21 statement process, there needs to be someone or a
22 party, such as the auditors, that remain purely

1 objective and unbiased and are truly the attesters,
2 rather than moving into the preparer role.

3 I've also heard various examples of places in
4 the statements covering estimates where auditors'
5 insights would be especially helpful in terms of
6 some context around those estimates. And it
7 strikes me that management is really in the best
8 place to put forward the public description of how
9 those estimates were derived and whatever context
10 is included in the required disclosures.

11 And should they do so, the auditor can then or
12 could, as the model changes or doesn't change,
13 could attest to those and stay, again, pure to the
14 attest role that the auditor is in.

15 I do agree with Mr. Elson's remarks that I
16 worry about the undermining of the audit committee,
17 but also, even more than that, I worry about
18 undermining the responsibilities that the preparers
19 themselves have for the financial statements.

20 Thank you.

21 MR. BAUMANN: Thanks, Joan.

22 Gary, is your card still up?

1 MR. KABURECK: It was, but --

2 MR. BAUMANN: Since you -- why don't you go
3 ahead, and then we'll turn to Mary Hartman Morris?

4 MR. KABURECK: Okay. Thank you. I'll be
5 quick.

6 But I've been reflecting all morning on what I
7 thought was a great discussion about I keep going
8 back to the concept of close calls here and began
9 thinking about how would you actually write the
10 guidelines when an audit standard or how would the
11 firms operationalize it?

12 Just give some really quick perspectives of it
13 is I think the most the Board could perhaps do is
14 write indicators of when a close call would be
15 required. I'm assuming you would be required to
16 disclose close calls in the MD&A. That's the
17 premise of where I'm starting from.

18 I don't necessarily accept that we should be
19 there, but assuming we are. How would you write
20 boundaries or guidelines for the auditing firms to
21 apply? I still think it would come down to a
22 series of judgments, to judgment with some perhaps

1 indicators, indicating when you should or should
2 not consider it.

3 So I think that's the first thing you need to
4 come up with. What is the boundaries of when a
5 close call would be deemed to be a disclosable
6 event in some capacity?

7 And then I started going through. I've been
8 involved with a lot of close calls over the years,
9 both as an auditor, as an audit committee member,
10 and in my own company. And a lot of times, I think
11 close calls come down to it's not all that
12 necessarily close in the way that perhaps really
13 seasoned financial regulators might see it. But it
14 comes down to the experience and the skills of
15 either the audit partner or the audit firm or the
16 management of the company.

17 I mean, I've seen it go both ways, where stuff
18 we thought was a close call and the auditing firms
19 did not, and the reverse is, of course, through
20 stuff we thought was a no-brainer to do it this
21 way, and the auditing firms thought it wasn't quite
22 so clear. So I just wanted to sort of keep that in

1 mind that some of this stuff will down to the
2 experience and skill sets of the players that are
3 doing it, as opposed to really and truly being a
4 close call.

5 My third point is that if you're going to
6 write guidelines on close calls, recognize close
7 calls do not always necessarily indicate high risk.

8 And I think high risk is perhaps the more
9 prevalent or perhaps the more important issue to be
10 concerned with. Because a close call doesn't mean
11 it's a wrong call. It just means it's a close
12 call. But I think just don't lose sight of close
13 calls and high risk are not necessarily synonymous.

14 And then, lastly, I would say close calls, one
15 size does not fit all. So let me sort of explain
16 what I mean by that. I mean, there is estimates
17 and there is judgments where there is recurring
18 estimates, say, your bad debt reserve. And a close
19 call in there may be a range of estimates -- I
20 mean, in theory you've got the critical accounting
21 policies disclosures to handle something like that.

22 And then there's what I'll call a transactions

1 close call, where there's a structured transaction.

2 And anybody that works in real estate knows that
3 minimum lease payments are 89.9 percent of the
4 deal. You do not have a capital lease.

5 Well, you understand the rules, but you move 5
6 basis points on your assumed interest rate, all of
7 a sudden, you're at 90.1 percent. So is that a
8 close call or not? Maybe it is. Maybe it's not.
9 But it's an established type of structure.

10 Then there's new structures no one else has
11 ever seen before, the first time an investment
12 banker created it or whatever. And again, maybe
13 it's a different set of close call disclosure
14 guidelines criteria.

15 So I'm just using those as examples that,
16 basically, the point is one size does not fit all.

17 So as you're trying to write guidelines and your
18 future standards, just to sort of be mindful of
19 that.

20 MR. BAUMANN: We are very thoughtful of the
21 fact of writing whatever standards we write here
22 will be a challenging task. And certainly, the

1 chief auditor will need the talents that we have in
2 this division to the greatest extent possible.

3 Mary Hartman Morris, you have the final word
4 on this subject. So we'll listen very carefully.

5 MS. HARTMAN MORRIS: Thank you, Marty. I
6 really appreciate being the closer today.

7 A couple of things. Thank you, Chairman Doty.

8 Thank you, all the Board members. Thank you, Ann,
9 for your thoughtful comments as well, and Steve
10 Harris. I think many of the comments today from
11 all of you were very important to all of us, as an
12 investor.

13 I know, Kevin, you mentioned that 800-pound
14 gorilla, I thought you were talking about CalPERS,
15 but from that perspective --

16 MR. REILLY: Not specifically.

17 MS. HARTMAN MORRIS: But from that
18 perspective, I am here to present CalPERS
19 viewpoints. I think the big point that was brought
20 up earlier was we are capital providers, and I
21 think the audit report is for the customer. So we
22 are the customer.

1 And so, I think there's a couple of things,
2 just a couple of things I wanted to go through, and
3 there was just five areas. Some of the things
4 about why it is our view from why we want an AD&A.

5 Again, who is the customer?

6 A little bit, some of the questions that you
7 brought up, Sam, about the confusion. And then --
8 or maybe that wasn't you, but someone else from
9 investors. And then the fiduciary responsibilities
10 of audit committees and whether or not we trust or
11 mistrust them. And then, of course, the
12 strengthening of the role of the auditor.

13 So just really quickly, I think it was brought
14 up by Joe earlier, too, the Investors Advisory
15 Group, Anne Simpson, our senior portfolio manager
16 sits on that, and we were talking about the
17 financial institutions, and she quoted we lost
18 something in the order of \$70 billion because of
19 the crisis. And those companies at the heart of it
20 had clean accounts and auditor's reports.

21 Every year, the audit report was the same with
22 an unqualified opinion. The opinion was the same,

1 but, well, Jack, maybe they didn't increase as
2 much. But the fees increased each year.

3 For a fund like CalPERS, the loss affects
4 ordinary people's lives and the pensions they
5 receive. So I think that is the reason why we
6 support an AD&A. We think that there is some
7 value.

8 I think someone mentioned, too, that we were
9 looking for forward future statements, looking for
10 statements. And we're not. I think the four keys
11 areas even mentioned through the ACAP -- key
12 financial statement and audit risk the auditor has
13 considered when conducting the audit and the extent
14 of how the auditor addressed those risks; the
15 auditor's assessment of the key estimates and
16 judgments made by management and how the auditor
17 arrived at that assessment. What keeps him awake
18 at night.

19 The quality of the accounting policies and
20 practices adopted by management. So you do have
21 the expertise there. And accounting applications
22 and practices that are uncommon to the industry.

1 You have that viewpoint. You go across industry.
2 We'd like to understand that.

3 And then, of course, unusual transactions and
4 significant changes to accounting policies. Many
5 more. I think I agree with Lynn. There are some
6 other areas, but I think those are the top four.

7 I think that we really believe that it's an
8 important -- there is some things on a -- it's
9 about governance. It's about transparency. So I
10 think, Professor Cox, you mentioned it was a
11 breakdown of governance. So I think that asking
12 auditors to step up to the plate is asking for
13 better governance.

14 I think that it is a communication tool, and I
15 don't necessarily agree with Mark. I don't think
16 we can live without it. I think we've gotten at
17 this point in our review, in our investments, I
18 think that it is important that we move to an AD&A.

19 And I don't think the common investor, the initial
20 investor, the institutional investor, I don't
21 think, and I agree with Florida, I don't think will
22 be confused.

1 I don't think that -- there was some issues.
2 I think there was some question about does CalPERS
3 have any -- a question about the inconsistencies,
4 if there were competing viewpoints. And I don't
5 think that there would be having inconsistent or
6 competing information between the auditor and
7 management is necessarily an issue.

8 Shareowners, which we are, are the owners of
9 the company. And obtaining both management and the
10 board's perspective, along with the independent
11 auditor, a third-party, independent person or
12 group, would provide a better understanding from
13 different perspectives for the stewardship of the
14 company. I think that's the important point. The
15 stewardship of the company.

16 And I think that, one last point, and no one
17 has really talked about it. But I think it's
18 whether or not the auditors work for their owners,
19 the investors, and how they're paid. I think
20 that's something that's held for a different point.

21 I mean, I know you can't bite the hand that feeds
22 you.

1 But I think it's really important to know that
2 an AD&A would help, I think, strengthen the role of
3 the auditor, be able to work with management a
4 little bit closer. And I think that the audit
5 committee, we do believe that they do have
6 fiduciary responsibility to the investors.

7 But again, it's not asking and it's not that
8 it's mistrust. We speak through our engagement
9 process at CalPERS. We talk to many audit
10 committee members, and we respect and understand
11 their viewpoints. But it's also respecting and
12 understanding the viewpoints of the external
13 auditor as the independent party.

14 So I think it will strengthen the role, and I
15 appreciate the opportunity.

16 Thank you.

17 MR. BAUMANN: Thanks, Mary, very much.

18 And thanks to all of you for a very energetic
19 and informative morning. We've received a wealth
20 of information from you on your views about the
21 auditor's discussion and analysis, its benefits,
22 and the views of some, its potential shortcomings.

1 We'll study the transcript thoroughly and dig
2 into your comments and continue our research in
3 this area. And again, appreciate tremendously the
4 quality of the comments we received this morning.

5 We're going to break now. Our lunch for the
6 participants is out in the foyer. And we should
7 try to return promptly by 1:15 p.m.

8 Thank you very much.

9 [Break at 12:21 p.m.]

10 [Reconvened at 1:21 p.m.]

11 MR. BAUMANN: Okay. Thank you. We will begin
12 the afternoon session. Thanks again, everybody,
13 for the level of energy and involvement this
14 morning. And hopefully, we can keep it up for the
15 next couple of hours.

16 We're going to turn our attention right now to
17 the -- another alternative for improving the
18 auditor's reporting model, discussed in the concept
19 release. And that is the required and expanded use
20 of emphasis paragraphs.

21 It was mentioned a number of times this
22 morning, that -- that is, another possible approach

1 could require auditors to point investors to the
2 most important aspects or greatest areas of
3 judgment and uncertainty in the financial
4 statements, and some have said maybe not as good as
5 the AD&A, from the investor's side. But maybe it
6 has the potential to do that.

7 Some of the questions, again, we'll -- we'll
8 want to address, but when anybody wants to comment
9 on this, please feel free to look at the questions
10 or -- or not, but what specific information should
11 the required and expanded emphasis paragraphs
12 include regarding the audit of the company's
13 financial statements, regarding the audit or the
14 company's financial statements?

15 What is the appropriate content and level of
16 detail regarding the matters presented in required
17 emphasis paragraphs?

18 And again, what are the potential benefits and
19 shortcomings of implementing required and expanded
20 emphasis paragraphs?

21 As I mentioned earlier, we've asked a couple
22 of participants to kick off this discussion, Joe

1 Carcello and Kevin Reilly. And I guess, from Joe's
2 perspective -- and Joe you -- I'm sure you'll add
3 whatever color you'd like.

4 But I was hoping you could touch on, as
5 somebody who's a supporter, as you articulated this
6 morning, a supporter of the AD&A as the tool to
7 improve auditor reporting, could you see the
8 emphasis paragraphs work? And -- and if so, how,
9 or if not, why not?

10 Then, Kevin, in the letter that the CAQ sent
11 to the PCAOB, in the comment letter, that did
12 include some examples of emphasis paragraphs.

13 And I guess I'd wonder, from the profession's
14 point of view, what your thoughts were in terms of
15 how we could require those and what kind of
16 boundaries we could put on those to -- so they
17 wouldn't turn into a listing of boilerplate
18 paragraphs, but -- but could actually work in a
19 meaningful way, if you've given any thought to
20 that.

21 But again, please feel free for your comments
22 to go whichever direction you'd like them to, so

1 let me kick it off with Joe Carcello.

2 MR. CARCELLO: Thanks, Marty. So Marty asked
3 me to introduce this topic, so let me -- let me go
4 ahead and do that.

5 One of the proposed changes to the standard
6 audit report would require the use of emphasis
7 paragraphs in all audit reports.

8 In addition, according to the Board's concept
9 release, these emphasis paragraphs could be
10 expanded to, one, highlight the most significant
11 matters in the financial statements, including
12 identifying where these matters are disclosed in
13 the financial statements, two, discuss significant
14 management judgments and estimates, areas with
15 significant measurement uncertainty, and other
16 areas that the auditor determines are important for
17 a better understanding of the financial statement
18 presentation, and three, with respect to those
19 significant matters discussed in an emphasis
20 paragraph, including judgment, and estimates, and
21 areas with significant measurement uncertainty, the
22 auditor could be required to comment on key audit

1 procedures performed, pertaining to identified
2 matters.

3 Before considering the potential merits of
4 requiring an expanded version of emphasis
5 paragraphs, let's take a brief look at how these
6 emphasis paragraphs are being used today.

7 I examined the most recent audit report for
8 every company in the S&P500, which represents a
9 meaningful percentage of the total U.S. stock
10 market capitalization. Only 5 of these 500 audit
11 reports contained an emphasis of matter paragraph
12 and 2 other companies had what I would consider an
13 "other" paragraph, basically in -- explaining why
14 they didn't audit equity-method investees.

15 More troubling than the base rate of inclusion
16 of emphasis paragraphs, 1 to 1.5 percent, was the
17 limited nature of these paragraphs, both in the
18 substance of what was discussed and the lack of
19 detail and transparency with -- with which these
20 matters were discussed.

21 These five emphasis paragraphs discussed,
22 which to give you something fun to do and that no

1 good academic would come without, handouts, I've
2 made copies of these five reports. And I've
3 highlighted in yellow the emphasis paragraph, so
4 you can kind of read along with me.

5 So these five emphasis paragraphs discussed,
6 which are being distributed to you now, number one,
7 the recapitalization of AIG by the Department of
8 the Treasury, the Fed, and the AIG Credit Facility,
9 this was one sentence, three lines.

10 Two, changes in Morgan Stanley's fiscal year-
11 end, from November 30th to December 31st, this is
12 one sentence, two lines.

13 Three, allocation of overhead costs from EW
14 Scripps company to Scripps Networks may not be
15 representative of actual costs that would have been
16 incurred by Scripps Networks had it been operating
17 as a standalone company. This was three sentences
18 and seven lines.

19 Four, similar issue regarding the allocation
20 of overhead costs for a former unit that has been
21 spun off, two sentences, four lines.

22 It is interesting to note that the last two

1 emphasis paragraphs were both issued by the same
2 firm, and it is also worth noting that four of the
3 five emphasis paragraphs were by one firm. And the
4 report language, although similar, was not
5 identical.

6 And the last emphasis paragraph was the
7 announcement of a definitive agreement to acquire
8 all of the outstanding shares of common stock of
9 Marshall & Ilsley by the Bank of Montreal, one
10 sentence, four lines.

11 If my friends at the PCAOB and at the firms
12 view these as informative audit reports, we are
13 using two radically different dictionaries. So to
14 meet the needs of investors, emphasis paragraphs
15 would have to be used very differently than they
16 are now.

17 How might this be done? To meaningfully
18 improve the audit report, emphasis paragraphs would
19 have to provide the type of information needed by
20 investors.

21 First, the emphasis paragraphs would need to
22 discuss significant risks identified by the auditor

1 and how the auditor's procedures and results of
2 these procedures were responsive to the identified
3 risks. AS number 12 provides the auditor a
4 framework for identifying significant risks.

5 Second, at a minimum, the emphasis paragraphs
6 would need to identify significant estimates and
7 judgments in how the auditor evaluated the
8 reasonableness of these estimates and judgments.
9 SEC guidance exists to identify significant
10 estimates and judgments.

11 Third, at a minimum, the emphasis paragraphs
12 would need to discuss significant unusual
13 transactions, how these transactions were audited,
14 and the results of these procedures.

15 Notwithstanding what Sam said this morning
16 about lack of compliments, here's my second
17 compliment in one day. I was pleased to see that,
18 in the CAQ's June 9th comment letter, on the second
19 line of item two on page four, that unusual
20 transactions would be discussed in a revised audit
21 report with required emphasis of matter paragraphs.

22 Finally, the emphasis paragraphs would need to

1 discuss alternative accounting treatments,
2 discussed with management and the audit committee,
3 the ramifications of selecting one alternative
4 other -- over another and the treatment preferred
5 by the auditor.

6 Again, there is SEC and PCAOB guidance on how
7 the auditor currently discusses these matters
8 internally.

9 From my perspective, although I prefer an
10 AD&A, the key issue is providing investors with the
11 additional information they need, whether that
12 information -- whether that additional disclosure
13 is in the form of an AD&A -- AD&A, required
14 emphasis paragraphs, or in some other manner,
15 because in my view, today's audit reports are
16 clearly not informative, which is at odds with the
17 PCAOB's mission statement, to provide informative
18 audit reports to investors.

19 MR. BAUMANN: Thanks, Joe. Kevin?

20 MR. REILLY: Yeah. Thanks, thanks, Marty.

21 And Joe, I do want to point out that, at lunch, I
22 learned that today is Sam's 39th birthday, so I

1 want to commend you for actually giving him two
2 birthday gifts today, so happy birthday, Sam.

3 [Laughter.]

4 MR. REILLY: All right. Let me -- I just want
5 to share a couple perspectives with you all on --
6 on the emphasis of matter approach and I am coming
7 from the -- from the perspective of having been a
8 member of the task force that the CAQ formed to
9 take a look at this issue over the last 12 or 15
10 months.

11 But you know, in general, we believe the
12 required -- key word there is required -- an
13 expanded use of emphasis of matter paragraphs is a
14 viable approach that will be helpful to investors
15 and could be implemented by auditors on a practical
16 and cost-effective basis.

17 As I mentioned, we -- we -- and as has been
18 raised before, we suggested this type of approach
19 back in June with our letter to the standards
20 group, and we continue to support the approach
21 articulated in that letter.

22 As outlined in the concept release, we think

1 the approach could be used to highlight matters
2 that, in the auditor's judgment, are the most
3 significant matters in the financial statements,
4 and identify where those matters appear in the
5 financial statements and related disclosures.

6 In this way, the approach would draw attention
7 to important items that may warrant further
8 investigation by financial statement users and
9 serve as a pointer to assist users in deciphering
10 the often very lengthy and complicated financial
11 statement packages.

12 We also think that audit report focus on these
13 areas could also help preparers enhance the level
14 of disclosures provided in those areas.

15 The approach is not perfect and I'm sure we'll
16 hear a lot about that in a few minutes, but we
17 think it could represent a meaningful improvement
18 to the auditor's reporting model as it currently
19 exists.

20 So let me just spend a couple minutes and go
21 through the questions, Marty, that the concept
22 released asks. And question five is, what should

1 be covered in the emphasis of matter paragraphs?

2 A couple thoughts here -- from a common sense
3 perspective, we think the objective of the approach
4 would be to have the auditor answer the following
5 question. What, in your view, are the handful of
6 most important matters impacting the financial
7 statements this year? That was Steve Harris's
8 thoughtful question that he raised first thing this
9 morning.

10 Understand, developing a workable auditing
11 standard that will answer that question is going to
12 be a bit challenge -- challenging, but we think it
13 can be done, and I know Marty and his team have
14 been diligently kicking the tires on that front for
15 some time.

16 But we suggest, perhaps, a two-part approach,
17 and the first would be for the auditor to focus on
18 the usual suspects, a significant accounting policy
19 or practice, a subjective accounting estimate, an
20 uncertainty, an unusual or infrequent transaction,
21 or other event, but then give a highlight in the
22 audit report to those types of usual suspects, only

1 to the extent that the matter was a significant
2 discussion with the audit committee, it involved
3 some substantial audit challenges during the
4 period, or underwent a significant change during
5 the period.

6 Once again, there are other ways to slice the
7 salami here, and I'm sure Marty and his group, with
8 the help of others, could come up with other
9 alternatives, but we thought that an approach like
10 that would respond to what we heard from investors,
11 as requiring additional focus in audit reports.

12 Question six relates to, what type of specific
13 content should be reflected in the emphasis of
14 matter paragraphs? And again, I'm going to sound
15 like a broken record here, but I think the focus of
16 our group is to have the auditor provide emphasis
17 in the context of objective descriptions of the
18 matter, as well as a direction to the reader, as to
19 where those items are covered by the company, in
20 the financial statements.

21 We don't think that having the auditor provide
22 subjective user impressions on the matter in the

1 audit report is really a constructive way forward.

2 We also don't think that the paragraphs need
3 to give the discussion of the specific audit
4 procedures that the auditor undertook relative to
5 those matters. As you can appreciate, we find it
6 really challenging to try to distill hundreds of
7 hours of audit effort in a particular area into
8 one, or two, or three sentences in a -- in a matter
9 being emphasized in the audit report.

10 At the same time, if we went -- and I think,
11 Jack, you raised this question -- whole hog and
12 went through page and page of description of the
13 various procedures undertaken by auditors in
14 different areas, we don't really think that's going
15 to be useful to investors.

16 So again, we don't think that the description
17 of the specific procedures in each emphasis of
18 matter paragraph makes sense.

19 However, as we suggested in our letter back in
20 June, we do think that the auditor, at the
21 conclusion of the emphasis of matter disclosure
22 areas, could state and identify that including --

1 that the -- our audit work included performing
2 specific procedures designed to address the risk of
3 material misstatements associated with the
4 individual emphasis matters, and that such
5 procedures were designed in the context of the
6 audit of the financial statements, taken as a
7 whole, again, and try to connect the dots that way
8 as opposed to a paragraph-by-paragraph description
9 of the procedures performed.

10 So let me summarize. The net benefits of this
11 approach -- we think -- we think it responds to
12 some of the investor requests for more information
13 and identification of the most significant matters
14 by the auditors in the -- in the financial
15 statements.

16 We think it may enhance, prepare as focus on
17 these disclosure areas and improve them. We think
18 it retains the established role of the auditor to
19 attest to information provided by management. We
20 think it will avoid some of the unintended
21 consequences that we discussed this morning,
22 relative to the AD&A approach. And we also think

1 it could be likely implemented in a practical and
2 cost-effective way.

3 Shortcomings and challenges -- as I mentioned,
4 coming up with a framework that will be effective,
5 that will help develop guidelines for an auditor in
6 terms of what goes into the emphasis of matter
7 paragraphs will be challenging. We recognize that.

8 But we want to make sure that the guidelines
9 are sufficient so that it doesn't give rise to too
10 many matters being emphasized, that really will not
11 be helpful to investors.

12 I'll also tell you that, you know, we -- we
13 spent some time looking at the French model, in
14 which the concept released identifies has been out
15 there since 2003. The French auditing body took a
16 -- a review of that approach, and went out with
17 some questionnaires, and -- and got some
18 interesting feedback.

19 And the review was mixed. Some were very much
20 in favor of it. Others raised issues with the
21 approach. One of the key issues raised in the
22 approach was, on the downside, was the excessive

1 standardization of the disclosures, but we think
2 that can be worked through, relative to the
3 approach that is ultimately adopted if we move
4 forward within this direction.

5 So again, long -- long story short, we think
6 this is a constructive way forward. It's one of
7 the -- one of the alternatives that the CAQ views
8 as being viable.

9 And with that, Marty, I'll -- I'll turn it
10 back to you.

11 MR. BAUMANN: Thanks, Kevin, and thanks, Joe,
12 for your -- both of you for your very thoughtful
13 comments to introduce this topic. Chairman Doty?

14 MR. DOTY: But, well, Kevin, first -- first,
15 let me say that over -- over lunch, what I heard
16 was a uniform compliment of the -- of the
17 discussion that you all have given us here on all
18 of these matters. The high quality of what you all
19 have brought to the table is -- is not lost on any
20 of us.

21 And this is -- this is really an informational
22 point, Kevin. Is what -- as I listened to it, is

1 this, what you have described -- is this really the
2 French model? It -- if it is -- if it differs from
3 the French model, which the firms have been
4 following now for some time, in what respect does
5 it differ? A pure informational point. It sounded
6 to me as if it was largely the French model. Is it
7 completely? What -- what's the difference?

8 MR. REILLY: Fair -- fair question, Jim, and
9 it -- it does differ from the French model, which
10 is a justification of assessments. And in that
11 model, they will identify things that I have
12 outlined, relative to significant estimates or
13 uncertainties and the like.

14 The French model will also go into details
15 relative to what the auditor has done to address
16 the risk of material misstatement in those, in
17 those matters, which as I said, is an area that we
18 don't think, on a paragraph-by-paragraph basis,
19 trying to distill the -- the level and effort of
20 audit work on those areas into a crisp sentence or
21 two really makes sense.

22 That's where it does, in fact, differ.

1 MR. BAUMANN: And in looking at the French
2 model -- and I'd looked at a number of financial
3 statements that -- that have -- that had
4 disclosures under those justification of
5 assessments. They typically were pretty much the
6 same.

7 I could pick up every financial institution
8 and it would say, "See the disclosure on fair
9 values, see the allowance for loan losses," and see
10 one or two other things, similar to off-balance
11 sheet disclosures, which -- and we chatted with
12 some people in our outreach who worked on these,
13 some auditors in France.

14 And there was some concern that they were
15 becoming rather boilerplate. How could we prevent
16 that from happening, Kevin, or -- or Joe, or
17 anybody?

18 MR. REILLY: Well, Marty, again -- again, if -
19 - if what we've suggested, which is simply an
20 identification of the -- in the auditor's judgment,
21 the most important matters impacting the financial
22 statements, I, for one, am less concerned about

1 this boilerplate issue because it -- a judgment is
2 involved in the actual identification on the
3 matters, which we -- we think will be helpful in
4 having investors sort through 200 pages of
5 financial statement data. We're telling the
6 investors -- and, Steve, to your point earlier this
7 morning -- you know, what -- what keeps you up at
8 night?

9 So I think the importance, Marty, of this
10 approach is -- is in the actual identification of
11 the matters and less so relative to what the
12 auditor says about those matters, because most
13 importantly, if it is a key, critical, important
14 issue, then -- then we have a responsibility to
15 make sure that the financial statements address the
16 material disclosures relative to those matters.

17 MR. BAUMANN: And I think we could write
18 requirements, as you indicated, or -- or Joe
19 indicated as well, that would link the required
20 emphasis paragraphs to what auditors are required
21 to identify, significant risks in the audit.
22 That's required under -- under our standards.

1 And to the extent there were significant risks
2 that were identified in the audit, how were they
3 addressed in the financial statements? That would
4 be one way to -- to kind of get at that, and
5 significant and unusual transactions have to be
6 identified. That's another way Joe mentioned as
7 well.

8 So it does seem to have the potential to -- to
9 put some fences around it, as well as require
10 certain areas. One area where you and Joe differed
11 -- and I just keep this dialogue going just for one
12 second longer. Joe did add that he thought that
13 auditors should indicate, when they identify a
14 significant risk, how they addressed that risk.

15 I'm just curious, because Joe is as aware as
16 we all are, that the audit includes potentially
17 hundreds of steps and thousands of hours in a
18 particular complex area, like allowance for loan
19 losses or fair value of financial instruments.

20 How might that be done in a meaningful way,
21 rather than reducing it to some sentence, we tested
22 fair values, which doesn't give investors much of

1 anything.

2 So I don't know if you have a thought on that.

3 Did Joe or --

4 MR. CARCELLO: Yeah, I -- I think it would be
5 challenging, Marty. I'm actually working on
6 something now with -- with another -- with a firm
7 to try to do something like that.

8 And you know, I think it can be done, but it
9 won't be easy. And, you know, at the end of the
10 day, that would be something that, you know, the
11 Board would have to decide. Could they?

12 If all you're going to end up with -- and I
13 think Kevin's right -- is, in France, the language
14 is so high level, and so general, and so common
15 across different issuers that there's no real
16 differentiation, no value.

17 And so unless you're going to get some
18 specificity -- but it's going to obviously have to
19 be summarized. It can't be 50 pages. Then it
20 doesn't have value. But I think you probably could
21 draft a standard that would require the auditor to
22 summarize the key procedures they performed in

1 different areas and, assuming it didn't devolve
2 into boilerplate, you would find differences across
3 firms and across clients.

4 Now, the firms would probably be uncomfortable
5 with that because they don't really want that. But
6 I think that level of transparency would be very
7 useful to users.

8 MR. BAUMANN: Thanks. Bob Kueppers?

9 MR. KUEPPERS: Just before we get deeper into
10 the question, I just -- you know, Joe, thank you
11 for the examples. I'm proud to see that the market
12 is thin, but we've got the major market share of --
13 of emphasis paragraphs.

14 I think one of the -- one of the -- one of the
15 points you were making, though, is that this stuff
16 is not all that meaningful. Now, it -- really, you
17 can't tell that unless you see the footnote that's
18 referred to because, if the footnote is fulsome,
19 then you don't have to repeat the language in your
20 -- in your opinion.

21 I will tell you one I can speak to. And that
22 is, Morgan Stanley changed its year-end from

1 November to December, and we haven't had a single
2 question about what that means. That one was
3 pretty clear.

4 But I do think that what's important is, the
5 EOM standard and the lack of, you know, deep
6 practice, is not what we're talking about. We're
7 talking about something where this would be
8 customary. It would be necessary. It would be
9 required, if you will, and you know, I think even
10 using emphasis of matter as a term of -- piece of
11 terminology is a little bit misleading because we
12 all think of, you know, these kinds of examples.

13 But we're talking about, actually, moving
14 things to the next level. And so we won't know
15 what it really looks like until we begin to work
16 with the Board on it, if -- if you go that way, how
17 -- how it might actually be embodied in a standard.

18 MR. BAUMANN: Thanks. Sam Ranzilla?

19 MR. RANZILLA: To -- Marty, to try to address
20 your question of the auditor response -- and over
21 the last 15 months, we have tried to build some
22 models out under an emphasis of matter paragraph or

1 maybe even other approaches, where the -- where we
2 would develop a framework where the auditor could
3 describe its response to whatever the anchor is
4 that causes you to have an emphasis of matter
5 paragraph, whether that's significant risk, whether
6 that's a critical accounting estimate.

7 Once you've determined what it is that the
8 auditor is going to emphasize, we've -- we've tried
9 to -- to develop models. And you know, I'll start
10 off by first saying, I think when Kevin refers to
11 the research note that was done out of France in
12 the -- I think it was excessive boilerplate, I
13 think that's pointed toward the auditor's response
14 piece or the justification piece of -- of those
15 paragraphs, because at least the ones I've looked
16 at, generally, have -- have evolved to, we came, we
17 saw, we conquered, and that's the auditor's
18 response to the particular evaluation issue at
19 hand.

20 But when -- when we tried to develop models,
21 either the -- to try to get something succinct that
22 didn't -- just didn't overcomment and take over the

1 auditor's report, it didn't give justice to the
2 level of work that -- that the auditor had done.
3 And in fact, that will become boilerplate, no
4 matter how hard we -- we try, or maybe -- maybe a
5 better word, it will become more standardized over
6 time.

7 We then took it and said, "Well, okay, if
8 that's not fair to what the auditor did and it
9 doesn't express the -- the absolute depth of what
10 the auditor got into, let's write one that -- that
11 goes into that."

12 And it was page, after page, after page of
13 description of what the -- what the audit
14 procedures were done, both from a control
15 perspective as well as from a substantive
16 perspective. At the end of the day, we just -- we
17 concluded that neither one of those were -- were
18 helpful.

19 Surely, though, the succinct model was not
20 giving an appropriate impression. The longer the -
21 - the longer model, people just aren't going to
22 read it. And if you're not familiar and you

1 haven't been down that journey on that audit, I'm
2 not sure how meaningful it was.

3 So I understand, Joe, you're working with
4 somebody. I -- you know, we're open to -- to
5 continuing down that, but just to maybe give some
6 background on what -- what we've been doing in
7 trying to -- to develop that model, we've -- we've
8 struggled with finding that, you know, the porridge
9 that's -- that's just right.

10 MR. BAUMANN: There are some other cards up,
11 but Joe, I assume, was responding back in this
12 dialogue we've been having, so Joe, I'll give you
13 the floor back.

14 MR. CARCELLO: Thanks. I would -- I would
15 agree with Sam, that this is not easy. Just the
16 little bit I've done so far, I would -- in working
17 with the -- the -- one of the firms, it's -- it's
18 not easy and I'm not sure we're going to be
19 successful. So I'm not -- I'm not surprised that
20 that's their -- the result you've had, Sam.

21 I think what would be, you know, useful -- and
22 I've tried to encourage the firms to do this, but

1 they -- they're going to obviously do what they
2 think is in their best interests -- is if -- if
3 when they have these projects on the way -- and
4 they've clearly put a tremendous amount of effort
5 into this in the last 15 months -- if they would
6 pull into their little networks, you know, one or
7 two investors, at a minimum, and then, Sam, when --
8 if you're reporting out and you're saying, "We did
9 this and it's so high level, nobody can really get
10 anything out of it," or, "We've did this and it's
11 75 pages, nobody will read it," I'm not saying I
12 don't personally believe you, but it would more
13 credibility, you know, if Mary was part of your
14 group and Mary said that.

15 MR. RANZILLA: Well, it's always good to know
16 where your credibility lies, but --

17 [Laughter.]

18 MR. CARCELLO: Yeah, yeah, well, just because
19 it's a different perspective.

20 MR. RANZILLA: All right.

21 MR. CARCELLO: Yeah, it's -- you know, it's an
22 investor perspective rather than an auditor

1 perspective. Yeah, yeah.

2 MR. RANZILLA: I -- I think that that's good
3 counsel. I will say that, before we got too far
4 into the -- into the project, we did meet with a
5 series of investors to try to get a better
6 understanding of what -- what people were -- were
7 concerned about, what were the -- the flashpoints,
8 so that we could focus it.

9 But -- but you're right. We didn't take the
10 results. We didn't take the 75 pages and three
11 sentences and say, "What do you think? Could --
12 could you make this work?" And so --

13 MR. CARCELLO: And you could.

14 MR. RANZILLA: And -- and -- but Reilly will
15 vouch for me that we actually did it.

16 MR. CARCELLO: Okay.

17 MR. REILLY: I -- I can guarantee that we did.
18 And just -- also, just to add some additional
19 color commentary, that the CAQ has also reached out
20 to a number of investors via this future role of
21 audit -- auditor project that they have underway.
22 And I think the feedback that -- that we understand

1 came out of those sessions was -- was that the
2 investors were really not that fired up about
3 hearing that much about what the auditor did.

4 They were really keyed into, what -- what's
5 the risk, what's the area, and -- and what is it
6 that, you know, keeps you up at night relative to
7 the issues?

8 MR. CARCELLO: Kevin, I think, you know, if we
9 go back to this morning -- and I, you know, did the
10 best I could to take notes as people were talking,
11 but obviously I don't have the transcript in front
12 of me -- what I heard this morning was, clearly,
13 some people, and some of the investors, clearly
14 said exactly what you just said.

15 But I think, if I went back through my notes,
16 there were other investors this morning who seemed
17 to indicate they would find value in more
18 granularity around what the auditor did.

19 So one of the problems is, you know, auditors
20 are not homogenous and neither are investors,
21 right?

22 MR. BAUMANN: So Joe and Kevin, I think, are

1 least reasonably on common ground, as am -- as am
2 I, that we could probably write some requirements
3 that could require auditors to point investors to
4 the most important aspects the -- of the financial
5 statements, where there's the greatest judgment,
6 the greatest uncertainty. And that might help
7 investors as much as the AD&A that a lot of
8 investors want, but it could go somewhere along the
9 way.

10 And by the way, anytime I say anything like
11 that, don't think that I'm espousing one -- one
12 version or the other. I'm simply commenting that I
13 agree that could possibly work, less -- les
14 agreement on how you get the audit down to a couple
15 of comments that are meaningful and -- versus a
16 lengthy discussion.

17 So with that, a number of cards have been up
18 and I look forward to your comments. We've got
19 first three, Larry Salva, Bob Guido, and Lynn
20 Turner.

21 MR. SALVA: Thanks, Marty, and just a -- just
22 a brief comment, just to expand or clarify that the

1 -- the reference to the emphasis paragraph or
2 whatever paragraph we end up calling it, directing
3 people to where, in the financial statements, these
4 items are discussed or disclosed, I think should be
5 -- we should think broader than that and not limit
6 it to the financial statements, because I think the
7 MDNA is a much more effective communication tool in
8 terms of management getting across certain points
9 that you may not put into footnotes.

10 So that's the -- the only point is that it --
11 you know, the auditor does need to read the MDNA
12 under other standards and look for material
13 inconsistencies, etcetera. Management may choose
14 to put a lot more information into the MDNA than
15 into the -- into the footnotes.

16 And there is a, at least in some sections of
17 the practice, a kind of a hesitancy to refer out of
18 footnotes into MDNA, as opposed to the other way
19 around. So if you just point to the footnotes,
20 they may not get the whole picture.

21 MR. BAUMANN: Thanks. Bob Guido?

22 MR. GUIDO: You know, originally, when I read

1 the information you all produced, I really wasn't
2 warm to this idea. I lived through, 30 or 40 years
3 ago, the boilerplate long form reports that we had
4 in the profession and we blew those up.

5 But the more I read and the more I hear about
6 this, I think there's a lot of possibilities here.

7 One -- one word of caution, if you wait until you
8 get this all right to get it out, you may never get
9 it out.

10 So the only advice I'd have on that is that,
11 whatever we produce here may not be 100 percent the
12 right way to go, but it is something that we could
13 do, and make changes, and modify as we go along.

14 I think the benefits of this approach -- we're
15 really going back to what Alan Beller said before
16 lunch. This could potentially increase the
17 quality, I believe, of management's disclosures
18 because of the specific references.

19 And when -- when I was an audit partner, a
20 very famous investor, Warren Buffett, on the audit
21 committee, used to ask me, "Bob, where's the road
22 map? Where's the road map? Tell me the four, or

1 five, or six items and this could be our road map."

2 So with that, there's going to be challenges.

3 Identifying the most significant matters, I think,
4 will be a challenge to some degree. There's going
5 to be a lot of judgment and subjectivity in that.
6 But I think the way the sample report was crafted
7 probably would -- would take care of that.

8 I am a little concerned with some liability
9 implications for the profession, but, you know, we
10 could probably work through that, so thank you.

11 MR. BAUMANN: Thanks, Bob. One thing, you
12 know, if I -- you -- we hopefully don't have to
13 worry about is us not getting it out. I see Steve
14 Harris every day, and can you imagine what would --
15 my life would be like if we didn't get something
16 out on this?

17

18 [Laughter.]

19 MR. BAUMANN: So there's little risk of -- of
20 that. And yeah, I think -- your other point you
21 made, I'd like to comment on that, too. I think
22 that is a valuable point to make. It's -- some

1 people say, "Well, you're simply pointing to things
2 in the financial statements."

3 But emphasizing that in the opinion, one does
4 think that the auditors might do a better job of
5 auditing, though, might do an improved job of
6 auditing those high-risk areas if they're
7 emphasizing that they're high-risk areas.

8 And one might think that the disclosure that
9 management makes about those high-risk areas might
10 be more robust if they're highlighted as well.

11 So there can be those other benefits in
12 addition. I would -- I would like to -- sorry to --
13 -- to give -- to interrupt the -- the list of people
14 with their cards up. But I wanted to go back with
15 Kevin on one thing.

16 The -- the mock -- the model report that the
17 CAQ sent in at least looks, to me, like it was more
18 than just pointing somebody towards a particular
19 footnote and not saying anything more about it.

20 You probably don't have it in front of you,
21 but -- but tell me, Kevin. Am I right in how you
22 approached this? And one example talks about

1 goodwill of X dollars, and the company performed
2 its impairment analysis, and -- and no impairment
3 was recognized because they estimated the fair
4 value exceeded the carrying value at that date.

5 However, the comparison was close. This --
6 that's a word like I heard investors say all day
7 long like that. The comparison was close and a
8 further decline in fair value of this reporting
9 unit could give rise to an impairment of the
10 goodwill balance in the future.

11 Boy, that sure sounds like stuff that people
12 were talking about before they wanted. Were you
13 expecting that, that was in the footnote, that? Or
14 was that added by you in the mock report as
15 additional color to the footnote?

16 MR. REILLY: No. The -- the -- I mean, that's
17 a fair point, Marty. I think the take-away was
18 that, that language would -- and that disclosure
19 would -- would be in the footnotes of the financial
20 statements.

21 So again, it is highlighting or giving
22 emphasis to the goodwill and the related impairment

1 evaluation as being a critical accounting estimate
2 and an audit challenge. But the language in there
3 was -- was essentially taken from what otherwise
4 would be in the footnotes.

5 MR. BAUMANN: The company actually would --
6 said it was close.

7 MR. REILLY: Yeah, yeah.

8 MR. CARCELLO: Marty, can I ask Kevin a
9 question? Because that's the one I -- I -- that
10 was my first compliment this morning. And -- and
11 Kevin, I think --

12 MR. REILLY: And now, you're going to take it
13 away.

14 MR. CARCELLO: No, no, I'm not going to take
15 it away.

16 [Laughter.]

17 MR. CARCELLO: I mean, yeah, I -- but I --
18 that's what I thought was really very, very strong
19 in your letter, so let me understand, because I
20 think Marty's question is an excellent question.

21 If a company didn't put that in the note,
22 Kevin, and -- but you concluded, as the auditor,

1 that it was close, you're going to stay silent?
2 Because that's the problem. That's the essential
3 problem.

4 MR. REILLY: Look, Joe, I don't -- please
5 don't read too much into the -- to the examples
6 that we -- we put into the letter. I think they
7 were put -- put there for illustrative purposes.
8 But I would tell you that, you know, as -- as we
9 kicked around the issues as auditors, and -- and we
10 were looking at a situation where a company was
11 doing a goodwill impairment analysis, and they were
12 on the rivet, relative to the comparison of book
13 value and fair value, you know, we would scratch
14 our heads saying, "Well, that -- that's something
15 that we would expect that would find its way into
16 the footnote disclosures.

17 MR. CARCELLO: Okay.

18 MR. BAUMANN: Thanks. Lynn Turner?

19 MR. TURNER: Thank you, Marty. I think you
20 raised a good question with respect to the example.

21 And again, I think it's the informational content
22 here that is important, not whether it's in an

1 emphasis or AD&A. What an investor needs, if we're
2 going to pay for this, is additional information
3 that will be useful and valuable to our bi-cell
4 analysis as we try to actively manage a portfolio.

5 It's not so much important to the indexers,
6 but for active managers, which I think is going to
7 be a much more important role going forward in this
8 economy, it's important that they get information
9 that can actually add value and informational
10 decision points in the active management.

11 What I heard Kevin say was, "The CAQ and the
12 firms are proposing that they would give, in
13 essence, investors a table of contents to what's in
14 the financial statements and asterisk the points
15 that they really want to make sure you read."

16 So we'll tell you, just as in the examples
17 that Joe handed out, as described in note one to
18 the consolidated financial statements, well, that
19 doesn't add any informational content, to me, as
20 I'm analyzing a company and financial statements.

21 And so the benefit of that would be zero. I
22 don't need another table of content. I don't think

1 the CAQ -- while they say they really want to make
2 change, I think that's wordsmithing, because I
3 really don't think they want to make change. I
4 think they want more of the same with the current
5 emphasis paragraphs.

6 I think we're looking for that additional
7 informational content that you just highlighted
8 with your question, Marty, with respect to what was
9 in the example.

10 Not only do we want to know what were the --
11 the big ticket items, as Kevin said, Kevin said
12 that when they met with investors, they wanted to
13 know what keeps the auditors up at night. That's
14 the informational content that can help us with
15 investment decisions. That's what's in that
16 completion memo.

17 That's not what's in a table of contents. A
18 table of contents, the proposal that Kevin just
19 described, would be of no value whatsoever. I can
20 already just read the footnotes and get the
21 information.

22 The only thing that he adds is an asterisk to

1 a table of contents that says make sure you really
2 read this footnote. So I see very little value,
3 whatsoever, with respect to that proposal and see
4 no value being added, in terms of information I
5 need to make a better informed bi-cell decision.

6 MR. BAUMANN: Thanks, Lynn. We've got Mark
7 LaMonte, Gary Kaburek, and Steve Buller.

8 MR. LAMONTE: Thanks. I'm going to agree with
9 Lynn and disagree with Lynn in my remarks. I am
10 enthused that the -- the firms seem to be getting
11 behind this a little bit and I think this does have
12 an opportunity to provide valuable value to the
13 financial saving user.

14 I spoke earlier this week at the AICPA banking
15 conference on loan loss disclosures. And one of
16 the things I highlighted in my -- my slides was the
17 proliferation of disclosures in recent years. If
18 you look at the 10ks of the big four U.S. banks,
19 they've gone from an -- on average, 141 pages in
20 2003 to 276 pages in 2010. And then you look at a
21 firm like AIG, their 10k this year was 482 pages.

22 The only people actually reading these entire

1 documents are some lawyers, some folks in the
2 accounting policy shops at the companies
3 themselves, and the auditors. Investors are
4 getting out commentary on earnings or making
5 decisions shortly after these annual reports come
6 out and they have no ability to sift through all of
7 this information.

8 We need that road map that Bob referred to.
9 We need to know what the three or five key things
10 that we need to read in those 300 or 400 pages are.

11 And I think Larry's absolutely right. You can't
12 stop at the footnotes. You also need to reference
13 the MDNA.

14 I think you'd probably be referencing both the
15 footnotes and the MDNA with an individual item.
16 Where I think this could add value beyond just
17 being an additional table of contents that Lynn was
18 referring to is, you not only need to tell the
19 investor what footnote to read, the auditor ought -
20 - should also be saying why they think this is
21 critically important to an investor's potential
22 understanding of this entity, so not just pointing

1 to where it is, but why you should read it, why
2 this information is critical to your understanding.

3 To go to some of Joe's comments earlier, I
4 don't think a lot of investors or financial saving
5 users are going to be all that interested in audit
6 procedures behind these critical areas. A lot of
7 investors -- I mean, you have a lot of poets with
8 MBAs and they're not all that interested in
9 auditing procedures. You don't have a whole lot of
10 former auditors or accountants out there in
11 investing, so they're not kind of junkies of audit
12 procedures or -- or what they mean.

13 There is one time where I think it would be
14 very valuable to understand the audit procedures.
15 And that is when there is a material weakness
16 reported in the other reports that auditors are
17 writing, and there's a reference to that material
18 weakness in the audit opinion. I think it would be
19 critically important for investors to understand
20 what incremental audit procedures were performed
21 for the auditor to get comfortable with that area
22 where there was a breakdown in controls.

1 Beyond that, though, I wouldn't be all that
2 excited about knowing about the audit procedures.
3 Thanks.

4 MR. BAUMANN: Thanks, Mark. Thanks for those
5 comments. Gary, if you don't mind, can I keep your
6 card up for a second? I was going to ask, if you
7 don't mind, if I defer to the SEC and let Brian
8 Croteau -- Croteau put his card up.

9 MR. CROTEAU: Thanks -- thanks very much,
10 Marty. I guess mine was really a -- a question.
11 Again, without sort of passing judgment around any
12 particular model, it -- it seems to me, from some
13 of what I was hearing, perhaps the power in the
14 emphasis of matter idea comes from the criteria
15 that one would use in determining what to put in an
16 emphasis of a matter.

17 So if it -- it were truly something that were
18 just, you know, find the 10 largest numbers in the
19 financial statements, anybody can do that and
20 there's no magic to that. But I think what Kevin
21 described in terms of the discussions with audit
22 committees or the extent of procedures the auditor

1 performed, if there's some amount of judgment in
2 determining what to put in an emphasis of matter,
3 which items to select, I -- I wonder if people find
4 benefit in -- in that to some extent.

5 Certainly, there may still be limitations to
6 the extent which -- which one finds that useful.
7 But to me, sort of the question around what the
8 right criteria would be to begin with in making the
9 selection of the items to emphasize might be the
10 important part of -- of this particular suggestion.

11 So I guess --

12 MR. BAUMANN: I agree. The criteria, I think,
13 is very essential. Thanks, Brian. Gary?

14 MR. KABUREK: Thanks, Marty. A couple of
15 comments, just sort of listening to this dialogue,
16 and I want to go back to one of the opening
17 comments. I had made my remarks this morning, but
18 I just listened to, you know, the relative merits
19 of the French model versus one or two sentence
20 saying, "We verified fair value," I think, was the
21 example.

22 I think that just goes back to -- the point

1 is, I think the Board needs to decide what level of
2 what knowledge should be assumed by the -- the
3 majority of the financial statement users, because
4 if you assume they know very little, the French
5 model looks pretty good. If you assume they're
6 reasonably knowledgeable in accounting, and
7 auditing, and the similar, well, maybe just saying,
8 "We emphasized fair value testing," is sufficient.
9 So I think -- I do think we need to wrestle that
10 one to the ground.

11 I think, you know, a couple of corporate
12 professional groups that I'm associated with, I
13 think in general, are supporting the emphasis
14 paragraph approach, you know, provided you keep it
15 to, you know, objective stuff and focusing on
16 accounting policies and the estimation process, you
17 know, the important areas of audit focus. I think
18 we can easily get our mind supportive of that.

19 I think I want to echo Larry and Mark's
20 comments about -- that you should be -- MDNA should
21 be available, you know, for reference in the
22 auditor's report. If that's the direction you go,

1 I'd probably take it further and go to the item
2 one, you know, business description, or risk
3 factors, or almost anything that's in the file
4 document.

5 I will tell you, my experience trying to even
6 have any footnote -- having a sentence say, "See
7 the MDNA, this page, this paragraph for more
8 details," has always been a problem with the audit
9 firms I've been associated with. He said he got me
10 auditing the MDNA. I says, "No, I think all your
11 auditing is -- on that page in that paragraph,
12 there's more information," you know.

13 So I think you need to wrestle, you know,
14 linkage to the MDNA inside the audited statements.

15 I think that's a narrow one that can be solved.

16 The -- I think -- and I don't know. Most of
17 the time in these meetings, these usually -- I've
18 usually -- when I've had a problem, I usually
19 suggest an alternative. This one, I actually don't
20 have one.

21 But when I think about the 10k process, I
22 mean, it's -- you file your statements in, I don't

1 know, say mid-February. Meanwhile, you're talking
2 about events up to 14 months earlier. And to say,
3 "Here's my audit processes in the critical areas,"
4 that's nice, but that's past news.

5 The question is, how do you keep that
6 evergreen, you know, going forward? And just, when
7 the audit emphasis areas change, I mean, should
8 there be some sort of reporting mechanism to
9 communicate that before 12 months later in the next
10 MDNA or in the next 10k?

11 And I don't have a solution and I don't even
12 know if it's a great idea. Well, of course, it is.

13 I suggested it. But the -- but I think you should
14 -- is there a way to, when audit emphasis changes
15 significantly during the year for unobvious reasons
16 -- it's one thing to make a big acquisition. I
17 mean, I think the world understands you're doing
18 something.

19 But how would you update that you're changing
20 your emphasis? And again, maybe staff work, you'll
21 conclude, is just not a good idea. But it's
22 something that occurred to me.

1 And then so my last thought -- and I'm going
2 to say it now; it's a little out of place, but I
3 might not get a chance later -- is, I'm looking at
4 the four areas of, you know, emphasis of matter,
5 ATA, and so on. If I was project-managing this
6 thing, I might almost break it into two projects,
7 you know, or release, because

8 I think emphasis of a matter and clarification
9 are going to be less contentious of issues. And
10 you might be able to wrap them up quickly, get them
11 out, make some improvements in the world
12 recognizing the ATA and probably assurance outside
13 of the financial statements will be more
14 contentious, going to be more prolonged, and so on.

15 So you almost might want to consider doing a -
16 - bifurcate the project. It's a thought, you know,
17 and let the staff work however it goes.

18 MR. BAUMANN: Thanks, Gary. Steve?

19 MR. BULLER: Thank you. Well, we -- we do
20 support the expanded use of the emphasis of matter
21 paragraph, but think that the AD&A, the emphasis
22 paragraph, and enhanced exposure all have their own

1 responsibility, and actually, interconnectedness.

2 So I think that the AD&A is important to us
3 because it does help define audit procedures on
4 significant areas and provides some perspective on
5 accounting principles. And I think, converse --
6 conversely to what Lynn said, our analysts believe
7 that the emphasis of matter paragraph should point
8 out the location of the financial statements of
9 certain things that, in the accountant's opinion,
10 are important for the reader to know.

11 And those are the, you know, the -- the new
12 financial statement disclosures, significant
13 transactions, and related-party transactions that
14 are material, significant judgments and estimates
15 with significant uncertainty, and also, significant
16 information about acquisitions, or related
17 financing, or -- and the reason they're important
18 to our analysts is, they believe that -- that
19 merely by having the auditor identify those in that
20 paragraph points to them that they were important
21 criteria in reaching the opinion.

22 So to the extent that they need additional

1 information on the procedures that were performed,
2 that should be in the AD&A. And the two we view as
3 complimentary.

4 MR. BAUMANN: Good. Thank you. Next, we're
5 going to Paul Haaga, Mike Santay, and Joan
6 Waggoner.

7 MR. HAAGA: Thank you, Marty. Remarkably, I
8 still agree with everything that's been said. My
9 favorite -- as I was sitting here listening to
10 this, I recall that my favorite movie title of all
11 time is Snakes on a Plane. It tells you everything
12 you need to know, nothing you don't need to know,
13 and is unlikely to become boilerplate because it
14 doesn't describe any other movie.

15 So following that, I do think shorter is
16 better. I -- that's why I suggested that the
17 emphasis paragraph is better than the AD&A
18 approach. I think there are things that one can
19 say, and we've gone back and forth on whether it's
20 simply a road map to the largest numbers, or at the
21 other extreme, it's the auditors giving their own
22 financial statements and taking over the role of

1 management.

2 I think you can strike a fine line between
3 those two. I think it should focus on matters
4 involving the audit and the audit process, but not
5 be limited to that, and can actually comment on
6 some numbers, and still be -- still be very useful
7 to investors.

8 Just some of the areas -- these have been
9 mentioned, but some of the areas that have been
10 suggested is significant issues that arose in the
11 audit, how they were addressed, areas of greatest
12 risk, how those have changed over time, and where
13 the audit emphasis was, significant estimates and
14 judgments, uncertainties, unusual transactions,
15 restatements, materiality standards.

16 Now, that sounds like an awful lot and I'm
17 trying to get it down to Snakes on a Plane. But I
18 think that, if you look back at the list of
19 examples, including the examples we've given here,
20 there are very few areas of concern that would have
21 been extremely significant to investors. And I
22 think pointing out those areas of concern and

1 saying something in just a couple of sentences
2 would have been very useful.

3 The challenge, of course, will be writing the
4 rule that reflects what I think a lot of us
5 understand or imagine a helpful emphasis paragraph
6 would have looked like.

7 MR. BAUMANN: Thanks. And thanks for the
8 colorful analogy. In particular, as actually, it
9 works in another way because I think the things we
10 want disclosed in emphasis paragraphs are the
11 snakes on the plan. So I think we're right on
12 target with that one. I wondered if Night of the
13 Living Dead worked, but maybe that has more
14 information than you need.

15 Mike Santay?

16 MR. SANTAY: Thanks, Marty. You know, as it
17 relates to the -- to the emphasis paragraphs, we're
18 supportive, along with others in the profession,
19 for many of the reasons articulated.

20 One of the things, if the Board decides to
21 move forward with this, is -- is going to be
22 important to think about is transition. You know,

1 as Joe pointed out, you know, well, there's -- then
2 there's dearth of information. There's been
3 nothing in -- in audit reports on emphasis, and all
4 of a sudden, you know, there's going to be a new
5 standard, which we wouldn't expect investors to
6 read.

7 But you know, all of a sudden, there's going
8 to be a lot of disclosures that are going to come
9 popping in. And I think, you know, our view is,
10 there -- there could be some -- you know, we want
11 to make sure that there's a good understanding of
12 what the -- what the framework for that's going to
13 be, and what inspectors -- what investors should
14 expect to see.

15 You know, that's not going to be operating
16 risk. I mean, if -- if somebody's got a major
17 contract with Wal-Mart that's disclosed, and you
18 know, we're not going to make a judgment on
19 operating risks or other types of risks. Those
20 are, you know, supposed to be disclosed in the
21 front part of the 10k, I think, in the risk
22 factors.

1 So I think it's going to be important to frame
2 what's being -- you know, we'll -- we, as auditors,
3 will have a good understanding because we're going
4 to, you know, beat the living daylights out of
5 this, and train our people, and that. But I think
6 it's -- it's going to be important for the readers
7 to understand what's being presented.

8 One -- one comment on audit procedures. I
9 think this one's difficult and I've heard
10 discussions on both sides, as to whether or not it
11 would be -- would be valuable. And you know, it's
12 -- it strikes me that there's times when management
13 does different things, depending on their view of,
14 you know, what they need to do to -- to validate
15 the assertion, you know.

16 Their -- if you've -- they've got a difficult
17 fair value measure, they may go out and hire a
18 valuation specialist. And that doesn't come
19 through the financial statements, but we, as
20 auditors, get comfort with that and we might think
21 -- decide we need to get less audit evidence
22 because we're vetting that specialist.

1 And so, you know, I don't know what the answer
2 is here, but I think there's -- there's some
3 aspects to what management's doing and -- and that
4 might not be visible in the financial statements,
5 and you know, the -- you know, all the work they're
6 doing to support their assertion and -- and our
7 response to that varies.

8 And so I think that's one of the challenges I
9 see in trying to decide what procedures to talk
10 about and what might be valuable, because if we
11 just put our procedures in there, and somebody
12 might look at it and say, "Well, they only did
13 this, somebody else did all this," that could
14 really be misconstrued. So --

15 MR. BAUMANN: Thanks. I was wondering if I
16 could just ask you a question, since it was
17 discussed by a couple of the other auditors.
18 Getting to the concern that Lynn expressed before,
19 that just pointing to the financial statements, the
20 -- the riskiest areas may not be enough, the table
21 of contents issue.

22 In the example that I read before, if the --

1 if the company had not disclosed that the
2 calculation of impairment was close, and you
3 concluded you could issue an unqualified opinion
4 without that sentence, do you think that additional
5 color is something that you could see auditors
6 putting into the emphasis paragraphs?

7 MR. SANTAY: I think the devil's in the
8 details on that one, Marty, I guess. And this kind
9 of goes to what some people view -- might view as
10 close, and versus not. And -- and so I think that,
11 as it relates to why it's important, I think, you
12 know, we -- one of my earlier comments today was,
13 you know, the -- the need for management to discuss
14 why it's important.

15 From an auditor perspective, I think I would
16 have a hard time, you know, making -- you know,
17 providing guidance to our folks as to what's close,
18 what's not. But I think that -- you know, I think
19 there should be sufficient disclosures in the
20 footnotes for the -- for the reader to be able to
21 determine that the -- you know, what methods were
22 used, and what assumptions were used, and

1 directionally, what -- you know, what -- why
2 management was able to conclude on the veracity.

3 So --

4 MR. BAUMANN: Jay, were you going to comment?

5 MR. HANSON: Yeah, Marty, I was just going to
6 respond to you -- your question to Michael about --
7 about whether an auditor would actually put that
8 language in -- they wish were in the footnote.

9 I'm suspecting that, if that threat was there,
10 it's going to be in the footnote, which in and of
11 itself, will improve reporting.

12 MR. BAUMANN: That, I think, is why some, such
13 as Lynn, might say that additional color would be
14 helpful. But I agree with your point, Jay. Joan?

15 MS. WAGGONER: Thank you, Marty. I would
16 additionally agree with what Jay and Mr. Santay
17 have said about this. It would be -- if it was
18 important, sufficiently important, to be considered
19 for EOM treatment, I think it would be one of those
20 things that you can't disagree upon. I think
21 management and the auditors would have to come to
22 an agreement and you wouldn't be able to issue the

1 financial statements without it being resolved, if
2 it was of that nature.

3 I did want to make one other comment about the
4 disclosure of audit procedures, building on what --
5 what Mike has said, that it might not be in the
6 investor's best interests for audit procedures to --
7 -- to become too widely known.

8 Audit procedures are not supposed to be all
9 that predictable, and if, as a matter of course,
10 audit procedures are disclosed for these more
11 interesting areas that will pop up in emphasis of
12 matter paragraphs, it might be detrimental to the --
13 -- the interest of investors in the long term.

14 There is an element of surprise that is -- is
15 supposed to be part of the whole audit plan that is
16 put together. And I'm not saying that this is
17 filled with mystical secrets or anything, but there
18 -- there certainly is, perhaps, that factor to
19 consider also, as we move forward.

20 MR. BAUMANN: Thanks, Joan. We have Florida
21 Rivera-Alsing, Wayne Kolins, and Alan Beller, and I
22 think Kurt Schacht gets the final word.

1 MS. RIVERA-ALSING: Thank you. I just want to
2 make sure that everybody understands that we value
3 audit. And I am a firm believer that our -- the
4 financial statements of our wholly owned entities
5 and joint ventures are audited.

6 But how much time do we really spend in
7 looking auditor's report, the opinion page itself?

8 A few seconds. The first thing I tell my people
9 is, "Are there three paragraphs?" "Yes." "Forget
10 about it."

11 There's only one firm that, to this date, they
12 still issue a one-paragraph audit report. We
13 sampled 25 financial statements of the financial
14 statements that we receive and only 1 firm issues
15 an emphasis paragraph. And -- and that's to the
16 firm represented to my left.

17 And in those instances, where paragraph --
18 emphasis paragraph is used, I felt like it is used
19 to limit the auditor's liability. It is just my,
20 you know, perception. I do not want to minimize
21 what Kevin said earlier, advising the users of the
22 financial statements for the significant matters

1 are -- is a step forward.

2 But is it enough? I do not believe so. I
3 look at the auditors to tell me why they believe
4 those matters that they have identified are
5 significant and how did they, the auditors, felt
6 comfortable enough to have the name of their firm
7 associated with those financial statements.

8 Do I have interesting reading for a 173-page
9 report? Absolutely not. And that is the reason
10 why we want you to cover only the significant
11 matters.

12 My concern, however, if we go to the route of
13 the emphasis paragraphs, how much information can
14 you really give to the investors in a couple of
15 paragraphs to make it meaningful?

16 Thank you.

17 MR. BAUMANN: And thank you. Jack, I hadn't
18 seen your card up, so I will do Wayne, Alan Beller,
19 Jack, and we'll still give Kurt his -- the last
20 word, since I promised that before.

21 MR. KOLINS: Thanks, Marty. I'd like to focus
22 on the audit procedures element and disclosures of

1 it. And if -- if the objective of disclosure of
2 audit procedures at the emphasis of matter
3 paragraph is to provide a picture of the strength
4 of the audit procedures around the particular area,
5 I'm not sure even a 75-page description of what the
6 audit procedures are is going to fulfill the
7 objective because it won't say what procedure
8 should have been done.

9 And audit's a very complex mechanism. There's
10 a lot of interconnected parts here because you have
11 to consider the risk of the area. You've got to
12 consider the -- the validity of the evidence. You
13 can describe a procedure that was performed, but if
14 the evidence that the auditor is relying on
15 shouldn't be relied on, that won't come across in
16 terms of describing a procedure.

17 It also depends on what the controls are, and
18 there could be one particular control that's
19 missing, that would be a house of cards for the
20 entire procedure to stunt.

21 So without knowing all of that, without
22 entering into a dialogue between the auditor and --

1 and the investor, you really can't get a full
2 understanding of what the procedures are in any
3 event.

4 And one other element that seems to be
5 missing, and hasn't been mentioned at all here, is
6 the PCAOB inspections. Now, the financial
7 statements at hand, that are just about to be
8 issued, obviously haven't been inspected by the
9 PCAOB. But it's possible that last year's
10 engagement was inspected by the PCAOB. It's
11 possible that, that particular engagement will be
12 inspected in the subsequent year.

13 So I think the PCAOB inspection oversight
14 provides an additional degree of comfort. I
15 believe -- I should -- I believe it would be to the
16 investors that the audit procedures are appropriate
17 in the circumstances.

18 Thank you.

19 MR. BAUMANN: Good points. Thank you. Alan?

20 MR. BELLER: Sorry. Thanks, Marty. First of
21 all, I guess I just want to, for purposes of the
22 transcript, import what I said earlier about AD&A

1 into here, because I think, as I said, I don't much
2 care. I'm not clever enough to know whether it's
3 part one or part two. And I think, if you get what
4 we were talking about, it's all the same.

5 I also think, though, that in thinking either
6 about AD&A, which I am not a great fan of, or
7 emphasis paragraphs, we all know investors want
8 more information. We have heard, and I think we
9 all know, that investors want more information from
10 the auditors.

11 But I think there's a line, and it's somewhere
12 -- it's -- sometimes, it's an easy line to draw,
13 and sometimes, it's a harder line to draw, but I
14 think, in continuing with this exercise, it's an
15 important line to draw.

16 Where is it better to get information from the
17 preparer and where is it better to get information
18 from the auditor? And I want to go back to the
19 goodwill example to kind of talk about that. The
20 example in the -- in the CAQ emphasis paragraph is,
21 they -- a segment was tested. No impairment was
22 found. But it's close. And if value goes down

1 further, there might be an impairment in the
2 future.

3 I actually had it, the very same question, for
4 Joe before lunch, that someone asked in this panel,
5 which is, suppose the issuer, suppose the preparer,
6 had said that in the financial statement footnote.

7 And it wasn't an idle question, because I actually
8 know of a preparer that said something like that.

9 And does it then go in the -- you still have
10 an emphasis paragraph about the impairment because
11 it's an important issue, but do you then go on?

12 You got the information. I think that's the kind
13 of information that's actually better from an
14 issuer.

15 And the real value of the emphasis paragraph
16 and the value of the process is, well, the
17 auditor's going to put it in if the issuer does it.

18 And I think the auditor has to put it in, in
19 answer to that other question.

20 But the practical outcome here is, the issuer
21 will put it in. And that's fine. And once the
22 issuer puts it in, does the auditor also put it in?

1 I'm not sure I care and I'm not sure whether I
2 care whether the standard says the auditor puts in
3 or doesn't.

4 Let's take this -- let's take this issue one
5 step further and let's stay with goodwill, even
6 though we get a little bit into the weeds. Let's
7 say that, if you do the kind of normal market value
8 of the enterprise, and then you look at the market
9 value of the segment as a portion of the market
10 value of the enterprise, there's clear impairment,
11 but the market just went down 67 percent in the
12 last six months.

13 And we were there, guys, two years ago. This
14 is not a -- this is not a hypothetical. And so you
15 then do a discounted consent to search flow
16 analysis to see whether, in fact, the market value
17 of the segment supports or the -- or the discounted
18 cash flow of the segment supports the market value,
19 notwithstanding the fact that the market value of
20 the enterprise is below what you get when you add
21 all the segments up.

22 Do you put all -- does -- it seems to me that

1 that's important disclosure. It's in the footnote
2 I'm thinking about. And it seems to me that, if
3 it's not in the footnote that I'm thinking about,
4 it goes in the emphasis paragraph.

5 That's getting pretty close to putting in
6 audit procedures, right? So it's very hard. It's
7 -- and again, if the issuer says it all in the
8 footnote, do you need to do more than flag it in
9 the emphasis paragraph?

10 Because the issue still is, it's close, and
11 the answer is yes, you do. But do you put all that
12 other stuff in? Don't much care. You want to get
13 the disclosure.

14 But the second thing that comes out of this
15 example is, sometimes you have to bounce a brush up
16 against the audit procedures to get to the kind of
17 disclosure that I think you're talking about.

18 The area where I think that actually -- that
19 I'm familiar with, where it would be the most --
20 the most common is fair value accounting. It's
21 very hard to talk about complicated fair value
22 accounting questions without talking about auditing

1 procedures in some -- in some cases, and so be it,
2 which leads me to my penultimate point, which is,
3 how do you, in a standard or in a set of disclosure
4 rules, because -- again, I think this is a two-part
5 exercise.

6 I think Brian's agency and this agency have
7 got to go down this road together to talk about
8 both issuer disclosure and auditing standards. I
9 don't think either agency will be able to
10 effectively write a black-letter rule around what's
11 significant. What are those 10 things that have to
12 be flagged in the emphasis paragraph?

13 I can almost promise you, you will not do that
14 successfully. What you -- well, you're really in
15 kind of a potter's story. You know it when you see
16 it. You set out the principles. Where are the
17 judgments hardest? Where is the estimation
18 hardest? Where are the numbers biggest? And you
19 put all three of those in a pot, and you stir it
20 up, and out pop the five, or six, or 10 things that
21 the investors care most about. And there really
22 are no black-letter rules you can write that will

1 produce that outcome.

2 The final point I would make, which has been
3 talked about a couple of times here, who are the
4 investors we're writing for? And what is their
5 audit knowledge? It is one of the great myths of
6 the U.S. disclosure system, that we are writing --
7 we are writing mutual fund disclosure for Aunt
8 Martha. At least, we should be.

9 But we are not writing 10k, 20f, 10q, 8k
10 disclosure for Aunt Martha and we haven't been for
11 25 years, at least. And you know, I'd love the
12 answer to be different, but it's not. And -- and
13 so what I think we really ought to be thinking
14 about, if we're thinking about what's effective
15 disclosure, think about fairly sophisticated
16 institutional investors, who drive valuation in our
17 market anyway, and Martha's a price taker. She's
18 not a price maker.

19 Write for those institutions, and write rules
20 for those institutions, and I think you're on the -
21 - you're on the right track. Don't write them for
22 me. I don't understand them.

1 MR. BAUMANN: Directors of corp fin give
2 consistent advice, because John White, at our last
3 discussion on the SAG on this similar topic, said,
4 "If the auditor is going to put the calculation as
5 close in the emphasis paragraph, it doesn't have to
6 because the client will put it in the footnote."
7 So we're getting consistent views, as -- as Jay
8 just --

9 MR. BELLER: Now, you know what John and I do
10 for a living.

11 MR. BAUMANN: Kurt -- Kurt, you're being
12 delayed one further, I think. Matt Torrey?

13 MR. TORREY: Yes, thanks, first of all,
14 to the PCAOB for the invitation to participate in
15 this forum, but thank you also for including so
16 many investors in the process. I think that's
17 very, very, very healthy development.

18 I'd like to second the comments made by -- by
19 Paul Haaga from -- from Capital earlier today,
20 twice earlier today. I think we've got a very high
21 level of consensus that -- that investors would
22 benefit from improved disclosure on many issues, to

1 ensure financial statements are as accurate as
2 possible and as transparent as possible.

3 I furthermore believe the use of emphasis
4 paragraphs would be an effective way to ensure that
5 this happens, pointing areas -- investors to areas
6 with the greatest financial statement risk, changes
7 in reporting, and, perhaps, most importantly, most
8 significant estimates and judgment.

9 So I think a lot of great points have already
10 been made. I'll limit my comments to that.

11 MR. BAUMANN: Thanks. And there was concern
12 that you were going to concur with Jack's comment
13 that you agree with everything that was said today.

14 And that was -- I've heard that twice. That was
15 going to be troublesome.

16 Jack?

17 MR. CIESIELSKI: Thanks, Marty. Just two things,
18 one thing to not worry about and maybe one thing to
19 think about. I hear a lot of auditors concerned
20 that investors want to see audit procedures and
21 worrying about putting out 75 pages of an emphasis
22 paragraph that includes audit procedures.

1 And I really -- I have to second Mark's
2 remarks earlier, that investors really don't want
3 to see that. At least, that's my belief. That's
4 what I've encountered in talking with lots of other
5 investors.

6 They don't want to recalculate an audit. They
7 don't want to re-audit something. They might want
8 to recalculate a number that appears in greater
9 detail in the footnotes, you know, details about
10 assumptions about, I don't know, the black shoals
11 option pricing model used in determining fair value
12 of items, whether it be compensation or
13 consideration.

14 They -- they might be interested in that, but
15 I don't think they really want to take one audit
16 report, and stack it up against another audit
17 report, and see which audit firm was tougher, or
18 something like that. That's just not within their
19 ken and it's not within the time they have allotted
20 to do their -- their jobs.

21 That said, I think that they don't care about,
22 you know, the audit procedures as much as they care

1 about the auditor's assessment of risks. What made
2 an auditor decide to do more audit procedures in a
3 particular area?

4 So I think, you know, the emphasis paragraphs
5 should speak more to what is driving an auditor's
6 decision in assessing risk in the audit of a
7 misstatement.

8 Something to think about is that we have pages
9 and pages of risk factors in the 10ks. And you
10 know, somehow, I -- I don't see a link between that
11 and the audit opinion. Those risk factors that
12 have been identified by the client -- they should
13 have some kind of an effect on the auditor's
14 assessment of what kind of procedures need to be
15 used in the audit.

16 So I think that it -- that might not be a bad
17 starting place for trying to figure out how an
18 auditor communicates the effective risks in an
19 audit to the investor, because the auditor is
20 supposed to be the eyes, ears, and nose of the
21 investor within the company. And they should be
22 doing some kind of risk assessment, and

1 communicating that to the investor would give them
2 a better idea of what kind of risks they take upon
3 themselves by being an investor in that company.

4 So I hadn't heard anything about, you know,
5 the risk factors section and trying to integrate
6 that, maybe, with some of these emphasis paragraph
7 issues that we're stumbling around on, so I just
8 wanted to put that out there.

9 MR. BAUMANN: Thanks.

10 MR. CIESIELSKY: Sure.

11 MR. BAUMANN: While I conceptually agree with
12 you on that, on the risk factors, Alan's profession
13 has done a very good job on those risk factors in
14 the 10ks that I read as well, that I don't think
15 anything's omitted these days from those.

16 Kurt, you have the final word, and then we're
17 going to take a break.

18 MR. SCHACHT: Thank you very much. Great job,
19 Marty and staff. This is a very through consult
20 and we appreciate the opportunity to -- to talk a
21 little bit about it.

22 I just spent four days living like a pioneer

1 up in New York because of Hurricane Irene. I think
2 a lot of us in the New York area had the same
3 experience. And I tried to get my kids to sort of
4 see the romanticism in living like pioneers, and
5 roughing it, and -- and they would have none of the
6 -- none of the discussions. I heard words like,
7 "I'm desperate," and, "Could you go out and get a
8 small generator so we can at least run the Xbox?"

9 To show you how desperate I was, as I had a
10 copy of the PCAOB handbook at home, and I had some
11 -- some good reading time with -- with the
12 handbook. And -- and I think we all sort of forget
13 that a lot of people that are on the IAG and -- and
14 on the SAG are not audit pros. They're not people
15 with accounting backgrounds. And it's important
16 for them to understand, really, how rigorous this
17 auditing profession is, and all the rules, and the
18 guidelines, and so forth that are there.

19 And I think the practice, generally speaking,
20 has evolved, and it's adapted, and it's -- it's
21 changed with the times, with the one notable
22 exception of the communication between the auditor

1 and the investor/shareholder. And that has not
2 kept pace, in our view.

3 And you know, the interesting thing that we're
4 hearing about some of these proposals in the
5 comment letters is that this is a monumental
6 change, if we were to do something, or that it
7 changes the fundamental precepts of the
8 auditor/investor relationship.

9 And the fact of the matter is that everything
10 else in finance, in investment, and in markets has
11 changed. And I'm not sure why this should be off
12 limits, and why we shouldn't make some -- some
13 pretty interesting and bold changes to how this --
14 this works.

15 Avoiding repetition, I -- I -- we agree with
16 how Ann and Steve Harris have sort of outlined the
17 investor concerns with respect to these issues.
18 That's where a majority of our CFA institute
19 respondents to surveys are, on three separate
20 occasions.

21 I think we're sort of -- this -- so we're sort
22 of at the point where this is a game of Clue. Do

1 you remember that game, where you had to guess
2 whether it was Colonel Mustard with the lead pipe
3 in the -- in the living room?

4 So we're talking about how should be giving
5 more information, what the information should be,
6 and where that information should reside. And
7 overwhelmingly, we hear from our investor members
8 that they want to hear it from the auditor, that it
9 needs to be from the independent expert, that, that
10 is important, that they want to have information
11 that's informative.

12 So if we're -- just again, I would agree with
13 the other speakers, that if this is just a
14 boilerplate description of the audit process, and
15 what reasonable assurance means, and that -- and so
16 forth, that that's really not what this discussion
17 should be about.

18 It's about that informative, customized
19 assessment of -- of the list. And I think we all
20 sort of know what's on the list and what's been
21 articulated in terms of risks, and judgments, and
22 so forth.

1 Where it resides, again, I agree with the
2 commentators that it's really less important about
3 where it resides and it's more important about who
4 and what is said. And I'm intrigued by this. Our
5 view is that it should be more closely connected
6 with the auditor's opinion, so there's no hunting
7 and pecking around all of the documents associated
8 with financial disclosure, so you see what the
9 auditor thinks, and what the auditor views, and has
10 judgments on in the opinion, either in these
11 emphasis paragraphs, or with another appendix
12 document, or however we might end up structuring
13 it.

14 So those are -- are -- some of our basic
15 comments. I'm intrigued by this -- this road map
16 concept. I don't think that we have really focused
17 on that as investors. I -- I do agree with Lynn
18 Turner's concern that a simple highlighting by the
19 auditor of where to look for more information and
20 more discussion from management is not the -- is
21 not enough.

22 But what Mark had -- what Mark LaMonte had

1 suggested in terms of an iteration where you talk
2 not just about where it is, but why you are
3 specifically trying to emphasize investor's
4 attention to that -- that location would be --
5 would be a step closer. Thank you.

6 MR. BAUMANN: Thank you, Kurt, and -- and
7 thanks everyone for a lively, entertaining, and --
8 but most importantly, very informative discussion
9 of the required and expanded use of emphasis
10 paragraphs, as one of the alternatives to improving
11 the auditor's reporting model. We'll -- we'll take
12 a -- running a little bit behind schedule. Let's
13 try to start again, if we can, at 2:55, and we'll
14 be talking about auditor assurance on other
15 information in the financial -- outside of the
16 financial statements.

17 [Recessed at 2:43 p.m.]

18 [Reconvened at 2:55 p.m.]

19 MR. BAUMANN: The next session on our agenda,
20 and I'm going to turn this over to Jessica in a
21 minute to lead the discussion here, is "Auditor
22 Assurance on Other Information Outside the

1 Financial Statements."

2 And that has come up a number of times today,
3 and I think this is another important area for us
4 to consider as to potential changes in the
5 auditor's reporting model.

6 And again, I'm not indicating any preferences,
7 because we don't have any at this point in time.

8 But I do want to repeat what Sam Ranzilla said
9 earlier today, that when you read what Alan Beller
10 and team put out in 2003, and what's required by
11 companies, even just the critical accounting
12 estimates, so much of it sounds exactly like what I
13 have been hearing throughout the day as to what
14 investors want to hear: Companies should address
15 material implications of uncertainties associated
16 with the methods, assumptions, and estimates
17 underlying the company's critical accounting
18 measurements. Such disclosures should supplement,
19 not duplicate, the description of accounting
20 policies that are already disclosed in the notes to
21 the financial statements. The disclosures should
22 provide greater insight into the quality and

1 variability of information regarding financial
2 condition and operating performance. The companies
3 should address specifically why its accounting
4 estimates or assumptions bear the risk of change,
5 so on and so forth, including a company should
6 analyze their specific sensitivity to change for
7 their significant estimates and assumptions.

8 One of the concerns I've heard is that this is
9 turned into boilerplate today and the value of
10 critical accounting estimates is not there. So at
11 least one of the proposals would be auditor
12 assurance on this, if we all believe audited
13 financial statements are of a higher quality,
14 because auditors audit them with the disclosure
15 that we get on the MD&A, or critical accounting
16 estimates, also achieve a higher level and the
17 spirit of what is in here, which is pretty much
18 what I've been hearing and what everybody wants is
19 required already.

20 So in any event, our next topic, "Auditor
21 Assurance on Other Information Outside the
22 Financial Statements," and Jessica.

1 MS. WATTS: As Marty mentioned, one of the
2 alternatives presented in the concept release is to
3 require auditors to provide assurance on
4 information outside the financial statements, such
5 as the MD&A, portions of the MD&A, or other
6 information; for example, non-GAAP information or
7 earnings releases.

8 An auditor providing assurance on information
9 outside the financial statements could improve the
10 quality, completeness, and reliability of such
11 information, providing users of financial
12 statements with a higher level of confidence on
13 information provided by management about the
14 company.

15 This alternative would increase the scope of
16 current auditor responsibilities, require the
17 development of new auditing standards, and require
18 coordination with the SEC.

19 So the questions for the concept release that
20 we would like to focus on today are on what
21 information should the auditor provide assurance:
22 MD&A, earnings releases, non-GAAP information, or

1 other matters? And then if the auditor were to
2 provide assurance on a portion or portions of the
3 MD&A, what portion or portions would be most
4 appropriate and why? Would auditor reporting on a
5 portion or portions of the MD&A affect the nature
6 of MD&A disclosures? And then what are the
7 potential benefits and shortcomings of implementing
8 auditor assurance on other information outside the
9 financial statements?

10 So I will leave up a summary of these
11 questions.

12 And for this topic, we've asked Mary Hartman
13 Morris and Mike Cook to help kick off this section.

14 Mary?

15 MS. HARTMAN MORRIS: Thank you, Jessica.

16 Chairman Doty; board members Ferguson,
17 Goelzer, Hanson, Harris; panelists, and guests, my
18 name is Mary Hartman Morris. I am an investment
19 officer with CalPERS, and I thank you for the
20 opportunity to discuss specifically auditor
21 assurance.

22 I'm here to represent CalPERS, the largest

1 pension fund in the United States with
2 approximately \$220 billion in global assets in more
3 than 9,000 public companies worldwide with 47
4 markets. CalPERS invests these assets on behalf of
5 more than 1.6 million public workers, retirees, and
6 their families, and beneficiaries, in order to fund
7 retirement and health benefits.

8 We continue our commitment to the concept of
9 global best practices that contribute to the
10 efficiency and effectiveness of capital markets,
11 including credible, high-quality financial reports,
12 which serve the needs of investors and other users
13 of financial information.

14 CalPERS is fundamentally a long-term fiduciary
15 investor with a vested interest in the stability of
16 the markets and integrity of financial reporting.
17 We believe financial reporting should provide users
18 the information needed to make informed capital
19 allocation resource decisions. The integrity and
20 quality of financial reports is supported and
21 strengthened by robust external independent audit
22 carried out objectively and undertaken with a good

1 dose of professional skepticism on the part of the
2 auditor.

3 As an independent expert, auditors provide an
4 independent opinion to the quality of financial
5 statements to instill confidence to providers of
6 capital, such as CalPERS. Currently, auditor
7 assurance is critical to investors' confidence in
8 the integrity of financial reporting and its
9 consistency based on U.S. GAAP.

10 You heard the robust discussion this morning
11 on AD&A, and we support the need for change in the
12 standard audit report, as we had said earlier. We
13 believe the PCAOB has the opportunity to make
14 substantive, robust changes that will improve
15 auditor reporting and provide real value to
16 investors and other users. And we support the
17 resources and efforts being focused on AD&A;
18 however, I know you have asked us to talk about the
19 MD&A.

20 It has been long recognized that financial
21 statements alone are not sufficient to communicate
22 overall performance of an entity. In particular,

1 MD&A has become, in our opinion, a core element of
2 the communication package for external reporting
3 purposes.

4 As underscored by many different individuals
5 and also by the principles for ongoing disclosure
6 material development reporting by listed entities
7 by IAASCO, an issuer should provide all information
8 that would be material to an investor's investment
9 decision, including disclosures in an MD&A.

10 So you know that the MD&A is meant to cover
11 four principal objectives, enables investors to see
12 the company through the eyes of management;
13 improves financial disclosures overall and provides
14 the context with which financial statements should
15 be analyzed; provides information about different
16 components of earnings and cash flow, and the
17 extent to which they are recurring elements; and
18 provides information about the risks to a company's
19 earnings and cash flow.

20 MD&A provides a context within which the
21 financial results and financial position can be
22 interpreted. Currently, auditors as part of their

1 engagement review the MD&A and consider whether
2 such information or the manner of its presentation
3 is materially inconsistent with the financial
4 restatements or represents a material misstatement
5 of fact. We believe the auditor could provide a
6 statement made on their current responsibilities as
7 it relates to MD&A within the AD&A.

8 Although the auditor would not be providing
9 assurance on future performance, CalPERS believes
10 auditors could through an AD&A provide a statement
11 of whether the MD&A is reasonable, whether
12 assumptions and conclusions are rational based on
13 the current work of the auditor and its review of a
14 company's financial performance.

15 CalPERS would support a full discussion of the
16 MD&A, specifically as a framework for integrated
17 reporting as further developed. Many of you know
18 the International Integrated Reporting Committee
19 released a request for comment on the integrated
20 reporting framework this week. So I think this
21 should also be considered as we think through the
22 MD&A.

1 Clearly, from the discussions today, investors
2 like CalPERS would recommend that PCAOB focus on
3 the AD&A and provide clarity within the AD&A on the
4 responsibilities of the auditor on MD&A.

5 We agree if assurance on other information
6 such as the MD&A is recommended that we defer to
7 the current attestation engagement procedures and
8 have the option to engage the auditor to attest on
9 an MD&A.

10 This is a great opportunity to determine which
11 issuers, if any, currently request their external
12 auditors to attest to their MD&A. And if an issuer
13 requests an attestation, then the benefits and
14 challenges should have already been outlined to the
15 audit committee and discussion of the benefits will
16 be well-articulated.

17 I think one of the questions you asked is the
18 greatest benefit, or if audited, what is the effect
19 if the auditor does provide an attestation. So I
20 think the greatest benefit of assurance would be a
21 driver or the impetus for management to do a better
22 job, because I think earlier you heard that MD&A --

1 management does not necessarily cover everything
2 MD&As is reflected to present.

3 So with that, I thank you, and I look forward
4 to hearing other people's views. Thanks.

5 MS. WATTS: Thank you, Mary.

6 Mike Cook?

7 MR. COOK: Thank you, Jessica. And thank you
8 to Marty and Jessica for the invitation and the
9 opportunity to express some views, which will not
10 be traditional with respect to this subject, but
11 are heartfelt, I guess.

12 The notion of auditor's assurance on other
13 information, I'd like to say that I don't get all
14 that concerned about the issue of assurance.

15 If I could involve the auditors in other
16 information and other financial communications,
17 whether or not that resulted in the expression of
18 assurance or a public communication might be
19 secondary to that. And I would use as an example
20 of that the current level of auditor involvement
21 with quarterly releases, which are much more
22 significant than the annual report that we have

1 been spending all this time talking about in terms
2 of the importance to the investor community,
3 market-moving information.

4 We have auditors involved with that, as
5 required, sometimes in greater depth than even as
6 required. There are no reports on that, that I am
7 aware of. It is very rare for those reports to be
8 made public. Probably a handful. They are
9 sometimes given to the audit committees and
10 sometimes not.

11 But what is important is the auditor's
12 engagement on behalf of the audit committee and the
13 company with respect to the quarterly reporting
14 process and the content of what I would put at the
15 front of the financial reporting train.

16 And if you can just take this as an
17 illustration, I view this financial reporting
18 train, and what we have been spending all of our
19 time talking about and spend lots and lots of money
20 on, and attention on, is the caboose of the
21 financial reporting train. The annual audited
22 financial statements coming out next March are the

1 caboose of the financial reporting train. And from
2 now until then, the remainder of the financial
3 reporting train, including the engine, will be
4 very, very important, will be what matters in the
5 marketplace, what matters for investors, not what
6 they will get next March after the year-end process
7 is complete.

8 I think things like this AD&A and EOM and all
9 these other things, or MOE, or whatever, EOM, all
10 of that is of great interest, but it is polishing
11 the caboose instead of paying attention to what is
12 going on in the most important part of financial
13 reporting.

14 And unfortunately, today, the auditors, at
15 least in terms of their relationship with the
16 outside world and the investing community, only
17 ride in the caboose. They don't ride in the
18 engine. The engine is driven by the management of
19 the company, and the management of the company,
20 with oversight and guidance from the audit
21 committee and auditors, to some extent, are
22 responsible for their earnings release.

1 The earnings release has good, real segment
2 information in it, vastly different and far more
3 extensive than the segment information you get in a
4 set of GAAP financial statements, what tells
5 investors what they need to know and what they want
6 to know about the company and about the company's
7 current results, and then use that information to
8 project the future results. The information is
9 timely.

10 Imagine a financial reporting world where we
11 said, "We'll get back to you next March, and we'll
12 have some AD&As and some MOEs and all that kind of
13 stuff for you. But in the meantime, we're not
14 going to have current financial information for you
15 to use in the marketplace." Not in this world.
16 That is not where it is.

17 In addition, the earnings releases include
18 lots of valuable information that is just not part
19 of the financial reporting process: the business
20 performance metrics of the company, lots of
21 different things about what goes on in the company
22 that never shows up in the traditional regulation-

1 based annual audited financial statements done once
2 a year.

3 And I would suggest that for -- and I realize
4 the limitations of the scope of the PCAOB by
5 legislative mandate, the scope of the auditing
6 profession. But if we don't find a way to get out
7 of the caboose and start moving up toward the
8 engine, and get engaged with what really matters in
9 financial reporting to the investor community, we
10 will be left behind. We will be obsolete. Whether
11 we're obsolete in 5 years or 10 years, maybe beyond
12 my lifetime, I don't know.

13 But we are increasingly obsolete spending all
14 of our time and all of this money and all of this
15 effort on the caboose of the financial reporting
16 system.

17 I'd welcome you to disagree with that point of
18 view, and that's okay. But ask the audit
19 committees where they're spending their time, how
20 they allocate their time between quarterly work and
21 confirming the 10-K when they finally get around to
22 the 10-K sometime the following year.

1 Ask the investors, any of the investors that
2 you in the corporate world have communications
3 with, or the investor community, give up something.
4 Give up the quarterly release or give up the
5 traditional regulatory financial filings. I don't
6 know anybody who would say that the earnings
7 release is not the most significant driving factor
8 in the marketplace that is absolutely essential to
9 investors. If I am missing that, the people I talk
10 to and the people that I hear from are not
11 representative of the investment community.

12 But I recognize that I really need to talk to
13 colleagues at the SEC about this, because that is
14 where this authority for change would have to come
15 from, if there were to be some higher level of -- I
16 hate the word "regulation" -- but oversight, let's
17 call it, and assurance with respect to quarterly
18 information.

19 Having made that case, let me then suggest a
20 little bit about then non-GAAP information, the
21 MD&A, and the other items that we are talking
22 about. I would urge that we do whatever is

1 reasonable to engage the auditing profession in
2 financial information that really is important on a
3 timely basis going to the financial community.

4 I would suggest that MD&A is the obvious place
5 to start, logically included in the discussion that
6 we have here. And I would urge that the auditors
7 at a minimum get involved in the elements of MD&A
8 that are comprehended by financial statements and
9 financial reporting -- estimates, judgments, so on
10 and so on.

11 And somebody might say, gee, they already have
12 that. Mary said that they're already engaged with
13 that at a standard of not including a material
14 error, being materially inconsistent. Not good
15 enough. In my opinion, they need to get much more
16 engage gauged with MD&A.

17 And to Lynn's point, what you said earlier, it
18 wouldn't make any difference. I will tell you, it
19 will make a difference. I have seen it make a
20 difference, because I've seen companies, and I sat
21 on the audit committees of one -- not currently --
22 where management was very clear that it was

1 management's discussion and analysis. It wasn't
2 the auditor's discussion and analysis. Butt out,
3 that's mine.

4 And to the point where we got to the stage
5 where the MD&A wasn't even complete. And the
6 auditors, without resorting to the audit committee,
7 didn't have any freestanding authority or
8 responsibility for the completeness of MD&A.

9 So I would suggest it won't matter in 95
10 percent of the cases, but engaging the auditors
11 with the direct responsibility for MD&A would be a
12 good idea, in my opinion. I'd like to see them
13 involved in all of what's in MD&A, with appropriate
14 protections for forward-looking information and
15 management opinions and things of that kind.

16 I just think engaging the profession in the
17 entire content of MD&A, and liquidity analysis and
18 things of that kind that are there, would be a good
19 thing, because I think the engagement will be an
20 improvement, will lead to improvement in the
21 quality of the information. Non-GAAP financial
22 information, stuff that can't go in the 10-Q, can't

1 go to 10-K, but goes into the earnings releases,
2 more often more meaningful information in the
3 headlines of the earnings releases, or at least an
4 equally prominent position, things of that kind
5 that are being reported that auditors have no
6 engagement with -- who would be more logical to be
7 involved with non-GAAP information than the people
8 who understand better than anybody else what GAAP
9 information is.

10 And it seems to me such a natural extension to
11 have auditors engaged. And again, I don't care
12 about public reporting, but engaged and perhaps
13 reporting to audit committees about the non-GAAP
14 presentations that the company is making, which are
15 very important to the investor communities.

16 So I would put MD&A as the car closest to the
17 caboose and non-GAAP information a little further
18 up in the train, not too far away from the engine,
19 which is the earnings release, and the information
20 that is going out on a quarterly basis and the
21 quarterly regulatory filings being one notch below
22 that.

1 So with that, I'd say we'd have to move
2 cautiously, and we will move deliberately in this,
3 if you agree with the premise that the world of
4 financial reporting would be greatly enhanced by
5 having the professionals of the auditing profession
6 engage with all of what really matters in financial
7 reporting, not just the stewardship confirmation 15
8 months after the beginning of the year, which tells
9 everybody about how the audit went and what was
10 important long after the financial statements for
11 four periods of the year have been in the
12 marketplace and been used for trading purposes.

13 So I think that each of these things should be
14 taken individually, and the marketplace should be
15 the driving force behind most of what we have here,
16 because if the market doesn't want it, and the
17 market says thanks very much but keep the auditors
18 back where they are, I really don't want either the
19 cost or the other considerations that go with
20 having them involved with the timely information
21 that is, in my judgment, driving the investment
22 process. That's a market decision to make.

1 But I think I would take the steps, MD&A
2 first; non-GAAP financial information next;
3 quarterlies are already being done, but never being
4 reported on; and then take the earnings release and
5 the content of the earnings release.

6 I can tell you from the perspective of an
7 audit committee chairman, we engage -- I don't mean
8 in the formal engagement, dollars and cents use of
9 that word -- we engage our auditors every quarter
10 in the earnings release, in other communications
11 are going forward from the company on a timely
12 basis, and we spend substantive time on it. We
13 don't just double-back at the end of the year and
14 ask how the quarters came out.

15 And I think that's where the profession needs
16 to go, and the PCAOB needs to help them get there.

17 So I think those are the points that I was
18 hoping to make. I guess one I would address was
19 overall the question about costs and benefit.
20 Costs here can be considerable, depending on which
21 portion of this financial reporting process you
22 engage auditors in that they have not been engaged

1 previously. The benefits, I think, would be far
2 greater than the costs, if we could enhance the
3 quality and credibility of all financial reporting,
4 not just the annual audited financial statement
5 process.

6 MS. WATTS: Thanks, Mike.

7 Mark Newsome?

8 Mr. Newsome: Thank you.

9 This topic touches on, I think, one of the
10 more critical areas that we deal with time and time
11 again with companies. Routinely, we look at
12 audited information, and we look at management
13 information, if I could use those two topics.

14 I think management financial information would
15 include the MD&A and other information that the
16 management teams provide to investors. And so, one
17 of the things we do routinely is we will look at
18 the management financials on a quarterly and annual
19 basis, and then we will go to the audit, since that
20 is a third-party verification. And we will try to
21 bridge the gap or reconcile between the two.

22 And in most cases -- I'm trying to think of

1 cases where we have done this on our own. You can
2 do it on your own occasionally, but in most cases,
3 you've got to call the CFO and ask how do we get to
4 the audit from what you provided us. And we do
5 this all the time. And so it's important to us.

6 So when you think about the information that
7 an auditor could provide in this area, it would be
8 helpful to get some type of assurance about the
9 information that management is providing, other
10 information or valuation reports that management is
11 using, such as an actuarial report or some other
12 type of valuation consultant, not necessarily to
13 opine on that work specifically, but to acknowledge
14 management is using other information to develop
15 these figures.

16 And that gets back to the AD&A to a degree, I
17 suppose, and maybe it fits somewhere there or
18 somewhere else. I'm not too particular on where it
19 fits, but it would be very helpful.

20 And then coming back to the role of the
21 auditor, I have heard a couple of comments. From
22 my perspective and I think from most investors'

1 perspective, it's not about mistrust of management
2 or the audit committee, it's about getting third-
3 party verification. And that's very important in
4 our role as an investor. And again, it's routine.

5 It's something that we do every year and with
6 every case.

7 MS. WATTS: Thank you.

8 Bob Kueppers?

9 MR. KUEPPERS: Thanks, Jessica.

10 In this area, terminology is important. So
11 I'm trying to remember in the last 8 years whether
12 I have ever been part of a conversation with PCAOB
13 and the folks here about something other than an
14 audit, and I don't remember that. So let me just
15 put out a couple of thoughts.

16 There are three levels of service we can
17 perform as auditors: attestations, reviews, and
18 compilations. And compilations are sort of off the
19 table for public companies.

20 It's fair to say that, and I can only speak
21 for our firm in this, we are open to doing more.
22 But if we declare that we are open to doing more,

1 someone will suggest that we're just commercially
2 motivated, and I find that offensive, but is just
3 what it is.

4 And the point is that if there is a call for
5 it, the chances are that we have the skills and the
6 mechanisms to meet that call.

7 Let me give you an example. Mary Morris had
8 some really good comments about MD&A, and made the
9 comment that we review that and maybe at some point
10 we should express a conclusion as to whether it's
11 reasonable. Under current standards, the
12 requirement is we don't review it; we read it. We
13 literally read it. And we are, by our standards,
14 required to observe and look for inconsistencies
15 between MD&A disclosures and the financial
16 statements that we do audit, and bring those
17 inconsistencies to the attention of management and
18 possibly the audit committee.

19 We could not conclude that MD&A is reasonable
20 unless we did a higher level service than what
21 existing -- I keep going to SAS 8. Maybe it's
22 something else. Or it's AU-something. But the

1 point is that those standards haven't changed in
2 many, many years.

3 And one thing I'll mention, it's a little
4 sensitive, but maybe it's time we did take another
5 look at those standards, because we literally read
6 the document, look for things that are
7 inconsistent, and raise the flag.

8 There is another level of service we perform
9 all the time, but it's not in the standards for us
10 to report on, and that's what we call agreed-upon
11 procedures. So it reminds me of what Mike was
12 saying about a press release. Press releases in
13 GAAP, it's called a document, but there are no
14 standards on which you could audit a press release.

15 But you can look at the numbers. You can tie
16 those numbers back to other financial information,
17 the company's records. You can tie it back to a
18 lot of things. You can recalculate percentages.
19 This is the kind of work we do all the time if
20 we're underwriters.

21 But if we were to do that kind of work and
22 there was a call for public reporting, there's no

1 standard under which we could issue that report.
2 Today's standards say you have to be part of the
3 crowd who agreed upon the procedures in order to
4 get a copy of the report.

5 I'm raising it for two reasons. I think those
6 standards at some point need to be dealt with,
7 because I think there are things we could offer
8 that are a lesser level of service but could give
9 some -- I'll use the word comfort, and I'll use the
10 word assurance, some information to investors or
11 others.

12 But in order to do that, we really would have
13 to ask our regulator here to take another look at
14 both of those standards, in my view.

15 So a fascinating topic. We could to do it a
16 lot easier if we don't have to publicly report.
17 But if that's wanted, we have to do some work on
18 the mechanism.

19 MR. BAUMANN: Does that include, for instance,
20 in a press release, for instance, beyond going to
21 tie the numbers into the company's records and
22 things like that, potentially concluding something

1 like: Based on your knowledge of the company and
2 its environment, that you're not aware of anything
3 misleading in the press release?

4 MR. KUEPPERS: And that would be what we would
5 we call a form of negative assurance. In other
6 words, "nothing came to our attention that."

7 And I think that there is something very
8 similar in the work we do in the quarter. So
9 certainly, that's a possibility.

10 MS. WATTS: Gary Walsh?

11 MR. WALSH: Thank you.

12 I work with a buy-side firm, and so I guess
13 I'm here representing investors, but I have spent a
14 few good years in my early career as an auditor, so
15 I have a lot of sympathy for some of the issues
16 that are taking place.

17 It strikes me that there is still an enormous
18 gulf between what auditors think that investors use
19 statements for and what investors think that
20 auditors do. And I think that as I went through
21 the choice of the four options that we have here,
22 I've been struggling for ways that we can bring the

1 two groups together.

2 I think if you talk to an investor, unless he
3 had some auditing experience, and asked him about
4 materiality, I think he'd be blown away to think
5 that auditors were passing on audit adjustments
6 that were more than that penny a share that he is
7 selling the stock based on, you know, the earnings
8 miss that quarter. And by the same token, I don't
9 think that auditors have much of an appreciation
10 for what in the world investors are doing. That's
11 too strong, but I do think that there needs to be
12 more of a tight alignment.

13 When I thought about, if you were to give
14 someone a financial statement, and say you've got
15 15 minutes to determine whether you're going to
16 invest in this company or not, I don't think that
17 the audit report would even be in consideration for
18 something that someone would look at. I think they
19 would quickly go to other areas. And I think that
20 you want to make sure that the audit report is top
21 of mind and certainly being closely considered, or
22 the audit process becomes somewhat irrelevant.

1 So when I look through the approaches, the
2 first, the AD&A, I really think that the management
3 is the right person to do most of the AD&A. When I
4 look at emphasis reports, I do worry about
5 boilerplate. I think that that has some interest,
6 and if you could make it so that you provided some
7 type of safe harbor for issues that were brought up
8 in an emphasis paragraph, then maybe you have some
9 carrot to have more open disclosure.

10 Going down the list again, I guess I would've
11 said that MD&A is really not that interesting. But
12 from Michael's discussion about the train, I really
13 think that that is the right place to focus
14 attention on being relevant. Quarterly earnings, I
15 think that's an area that it's still kind of the
16 Wild West in terms of things that were reported one
17 quarter and then are changed the next quarter. I
18 still think that that is too loose, and investors
19 would really benefit from having more consistency
20 and having the oversight of auditors being
21 involved.

22 And so the last part, the last option, I think

1 we can beef up the audit report to provide more
2 clarity into what is going on.

3 But those are just some random thoughts. I
4 really do like the idea of having them involved in
5 the quarterly report.

6 MR. BAUMANN: If I could just follow-up, Gary,
7 with a question, just to make sure I understood the
8 point?

9 If a company reported a \$1.50 a share in the
10 quarter -- or for the year, either way, because the
11 auditors do quarterly reviews, too. And the
12 auditors had an adjustment which really would've
13 brought it to a \$1.49, but they passed on that
14 penny adjustment there, are you suggesting to
15 investors that's important always, or that's
16 important only if the announced earning target for
17 the quarter was a \$1.50?

18 MR. WALSH: No, I think going back, I think
19 it's very important for auditing to have
20 materiality thresholds. That's very important.

21 I don't think that investors understand that
22 enough. And I think to have more appreciation

1 there, it would give investors a better sense of
2 where they should focus their attention, and not
3 purely on that penny. We tend to be pretty long-
4 term-oriented investors, but even saying that, I
5 think the quarterly reports are full of great
6 information.

7 MR. BAUMANN: Because auditing standards do
8 require -- materiality standards do require
9 auditors to consider not just quantitative
10 misstatements, but qualitative. And that is if the
11 market would think that that penny was important
12 because of what the company had announced, that
13 could be qualitative material, even if it was a
14 relatively small percentage.

15 But you're right, maybe investors and auditors
16 aren't on the exact same plane with respect to that
17 entire subject.

18 MR. WALSH: And just for the record, that
19 penny isn't important to anybody. It's the fact
20 that your revenue growth, your operating margins
21 assumption, your competitive advantage period, you
22 realize that all on the same day that they show the

1 penny disappointment, and that's why you have such
2 a large adjustment to the value that people place
3 on the stock, not because it's a penny.

4 MR. BAUMANN: Thank you.

5 MR. WALSH: You bet.

6 MS. WATTS: Lynn Turner?

7 MR. TURNER: Interesting to hear the analogy
8 to the caboose. I've heard some say that they ride
9 the caboose and then get out at the end and bayonet
10 the dead.

11 But I actually think the auditors aren't that
12 far behind. I think they're probably more up in
13 the diner or the dome car. I don't think they're
14 all the way back at the caboose.

15 And in fact, auditors do have to do a full
16 review of the 10-Q now, underneath the standards.
17 There's not a report required to be issued and
18 filed. I was there when we did those rules. The
19 reason we didn't require it was because at the same
20 time we were doing the audit committee rules and
21 there was enough pushback not only from the
22 business community, but one of the Big 6 at the

1 time also opposed having a report be filed. And we
2 went about as far as we thought we could.

3 I think that, certainly, audit committees, if
4 they aren't, they should be, the chair should be
5 requiring a report. They're fools if they aren't,
6 and they aren't doing their jobs, if they aren't.

7 But I would certainly think that getting those
8 reports in the filings would be very beneficial. I
9 agree with Mike that getting full assurance on the
10 earnings release would be very beneficial and good,
11 and I'd do the same thing on the full MD&A. I
12 think just the critical accounting policies is a
13 waste of time and money.

14 However, having said that, we've seen in
15 recent days in this city where legislation is being
16 introduced to exclude probably 80 percent, 85
17 percent all public companies from SOX 404. And the
18 reality is with the political climate in this
19 country at this point in time, there is absolutely
20 zero chance -- none, nada -- that those type of
21 things could be implemented by this board or the
22 SEC.

1 And having lived through that, I think it
2 would be a total waste of this board's time and
3 money, and investors' money, because ultimately
4 we're paying the fees, to go down that path and
5 waste your time on it. Because just politically,
6 it's not going to happen at this point in time in
7 this city.

8 It's unfortunate. I couldn't agree more with
9 Mike. I think he's absolutely right. But in this
10 city, you can only take on so many fights at a
11 time. The board is already taken on a couple of
12 major fights here, and so I would turn around --
13 while I think those are all great, and I'd love to
14 see them all, I think at this point in time, it
15 would be a waste of time and resources, because at
16 the end of the day, you try going down there,
17 you're going to have legislation introduced so
18 quick, your head will spin, that will cut you off
19 at the pass, especially with the legislation we're
20 already seeing in recent days pop up.

21 So I'd love to see it, but you have to deal
22 with practical reality in the city, and it just

1 can't happen at this point in time. But it's
2 unfortunate. It would greatly benefit investors.
3 I think it would be well worth the money. But it's
4 not a reality.

5 MS. WATTS: Jack?

6 MR. CIESIELSKI: Thanks.

7 I have a few thoughts along those lines of
8 Lynn's, but a little different maybe.

9 First of all, I'm not sure what kind of form
10 the assurance on an MD&A would take. That's kind
11 of a free-writing prospectus sort of thing that the
12 managements do. And unless you are going to be
13 writing a whole MD&A yourself and comparing it to
14 what the management would come up with, I'm not
15 sure what you would say in an opinion on the MD&A.

16 And that really did not jump out at me in the
17 concept release.

18 But going back to what Mike said in the
19 beginning about the train, the caboose, et cetera,
20 you're right, absolutely right, that earnings
21 releases are important because they move the
22 market. But they move the market because they're

1 the first new information after the end of the
2 quarter. So what you're proposing is to put some
3 kind of assurance on the MD&A, which comes out much
4 later in the quarter. And the time you're going to
5 take to put assurance on the MD&A, whatever form
6 that might be, is going to push that Q filing
7 closer to the deadline, farther away from the time
8 that the earnings release is made.

9 So I find that further cheapening, or maybe
10 not cheapening is the right word, but making the Q
11 somewhat less useful for the investor, because it's
12 going to come out later. Maybe it's got assurance,
13 and maybe that compensates for the fact that it's
14 later, but if you're going to be putting some kind
15 of audit procedures or assurance procedures on it,
16 you're going to have to spend some more time,
17 unless it's just what you're doing now, reading and
18 reviewing and then putting the assurance opinion on
19 it.

20 I think that if you're going to do anything
21 along these lines, you have to do the whole package
22 at one time. You have to put assurance on the

1 earnings release, which is maybe in conflict with
2 GAAP, and have the GAAP numbers out at the same
3 time. And I think the solution is really to do the
4 whole thing at once, and not have companies, and
5 I'm not sure how you legislate this, but not have
6 companies file an earnings release, issue an
7 earnings release, without the Q.

8 The whole package all at once is going to give
9 everybody all the information they need with all
10 the assurance. And I think if you piecemeal it by
11 doing assurance on the Q later, then you're
12 actually going to give management a reason to go
13 out and put the earnings release out sooner or
14 increase the gap between the two, and I think that
15 that's not a good thing for investors.

16 So for what it's worth.

17 And I think that would be an enormous amount
18 of rules overhauling that goes far beyond changing
19 the auditor's opinion. I'm not sure how you could
20 get that synchronization of the earnings release
21 with the Q in this kind of climate. For what it's
22 worth.

1 MR. BAUMANN: I guess that would be something
2 that the SEC would have to take up, in terms of an
3 earnings release would have to accompany -- the Q
4 would have to accompany the earnings release and
5 the SEC would also have take up whether or not to
6 report that Lynn said auditors have to, for
7 procedures right now, in connection with the
8 quarter, but they're not required to issue a
9 report. And I think Lynn suggested he thinks that
10 report should be accompanying the quarterly
11 financial statements, I think -- right, Lynn? --
12 which would require SEC action.

13 And I think those are all good points, and
14 worthy of discussion.

15 In theory, that one doesn't have any extra
16 cost at all involved. If the review is already
17 being done, putting a report attached to it has no
18 cost.

19 With respect to your comment, I just want to
20 make sure I have it correctly. There are existing
21 attestation standards for reporting on MD&A. There
22 was an example of that in the concept release and

1 in the mock report that the CAQ put out. It talked
2 about, we have examined the critical accounting
3 estimates, and it talks about what that means. And
4 it gives, "in our opinion, the presentation of the
5 critical accounting estimates," and it goes on and
6 talks about what that opinion means.

7 MR. CIESIELSKI: I'll have to go back.

8 MR. BAUMANN: So it's worth looking at that.
9 There are some existing criteria for that.

10 MR. CIESIELSKI: I was thinking of it in terms
11 of an audit opinion, just, "We have examined the
12 financial statements, and it's in accordance with
13 GAAP." We don't have a body of -- well, we do have
14 the PCAOB standards, so okay.

15 MR. BAUMANN: But whether we amend that or not
16 would be another factor, but there are existing
17 standards there.

18 MS. WATTS: Mark LaMonte?

19 MR. LAMONTE: Thanks. Very interesting
20 discussion. I very much agree with what Mike led
21 off with, the train analogy, where we're talking
22 about the caboose being the driver of what we're

1 thinking about here.

2 One of the issues that we're dealing with --
3 and this may be something we might not be able to
4 really solve in this context; it might be a much
5 bigger issue -- is we're dealing with a very
6 archaic form of financial reporting that doesn't
7 necessarily reflect how investors make decisions or
8 the information they use to make decisions.

9 It's really about data with investors and the
10 flow of data to investors. You don't have a lot of
11 investors necessarily staring at balance sheets.
12 It's about data that's getting into models. That
13 may be getting into models by someone in India
14 rekeying it at \$10 an hour, or it may be a junior
15 person putting it in.

16 But it's not really about financial
17 statements. It's about the data that drives
18 decisions and whether there is assurance over that
19 data. Some of that data may be extracted from
20 financial statements or earnings releases and be
21 your traditional balance sheet metrics, which are
22 subject to audit, or would be subject to audit

1 after the fact.

2 Other pieces of information, which may be
3 absolutely critical, might be more nontraditional
4 information. If you're looking at Wal-Mart, a key
5 driver might be same-store sales, which is never
6 subjected to audit but is absolutely critical to
7 making a decision on whether or not to invest, to
8 buy or sell their securities.

9 So I think at some point we may need to really
10 refocus on the flow of data rather than the
11 preparation and auditing of the financial
12 statements. And this may be in part why the
13 financial statement presentation that the FASB and
14 IASB has been working on has gotten bogged down.
15 It's just recasting this old, archaic view of
16 financial reporting and not focusing on data flow
17 and then assurance over that key data.

18 So this might be a much bigger issue than can be
19 addressed in this project, but I think it's
20 something that the PCAOB and the industry really
21 need to begin to think about.

22 MR. BAUMANN: In that context, would you be

1 supporting auditor association with XBRL?

2 The data that is probably being sent over to
3 India for use in --

4 MR. LAMONTE: If anybody was actually using
5 XBRL, absolutely.

6 [Laughter.]

7 MR. KABURECK: Don't assume anyone is using
8 it.

9 MR. BAUMANN: Thank you.

10 MS. WATTS: Peter Nachtwey.

11 MR. NACHTWEY: Thanks, Jessica.

12 Well, the first thing I have to share is both
13 Mike and Lynn are taking me back early in my career
14 when I was told what the definition of an auditor
15 was, which was somebody who comes in after the
16 battle was lost and bayonets the wounded. But I
17 was also told that by an attorney -- so, Lou, don't
18 kick me -- who defined lawyers as those who come in
19 after the accountants and strip the bodies.

20 [Laughter.]

21 MR. NACHTWEY: So on that ghoulish note, on
22 this proposal, as I said earlier, I definitely

1 would be supportive, but with some caveats, because
2 I do think it makes clear to investors, more clear
3 what the scope of the auditor's involvement has
4 been outside of the basic financial statements.
5 And it more or less, frankly, acknowledges facts on
6 the ground, as far as my experience shows.

7 I also think that probably this may be one of
8 the most important things that we're talking about
9 today as a relates to non-GAAP information, because
10 I spent a lot of time on the road with analysts and
11 investors, and, frankly, they spend very little
12 time grilling me about the GAAP information. They
13 spend a lot of time drilling me about the non-GAAP
14 information.

15 So I think it's especially important that, as
16 I think Mike said, that the auditors, well, you
17 say, gee, they're trained in GAAP, well, they're
18 trained in numbers, they're trained in financial
19 analytics, a lot of things that lend themselves to
20 being involved with that information. And I do
21 think it would be helpful. And frankly, it might
22 cut down on the number of questions that I need to

1 answer, because people don't think the auditors are
2 involved with that information today.

3 So I also think the quality and consistency
4 within industries would be enhanced if auditors
5 were involved with that information, and by
6 derivation, this group, the PCAOB.

7 Conversely, on the earnings release front, I
8 don't think auditor reporting on these really gets
9 you over the cost-benefit hurdle from what happens
10 today, because auditors are heavily involved in the
11 Qs, as several have said, and they ultimately
12 report on these anyway, in terms of the footnote
13 that is in the financials at the end of the year.

14 So I think that management and auditors stay
15 pretty close already on the numbers. And where
16 they don't, you see embarrassing situations where,
17 after preliminary earnings release, the numbers are
18 revised when the ultimate filings go in, and I
19 think that's already a sign of the involvement that
20 auditors have there.

21 I just have a little trouble imagining how an
22 auditor report on an earnings release, and

1 particularly the tight timeframes that the market
2 gives us to get earnings out, how that would work.

3

4 So those are my views.

5 MS. WATTS: Larry Salva?

6 MR. SALVA: Thanks, Jessica.

7 To follow up on something that Mark mentioned,
8 data assurance, or I would put it more association
9 with, and maybe that follows up on the last comment
10 as well, in that I think it would be important for
11 investors to know that auditors are somehow
12 involved with, not necessarily providing assurance
13 on, because somehow that gets more difficult to get
14 into places.

15 And I note within the concept release that it
16 notes that there is no requirement for an auditor
17 to provide assurance on earnings releases or non-
18 GAAP information. Well, I'd also note that there's
19 actually no requirement for them to even read it
20 for material inconsistencies, because it's not
21 included in the document that includes audited
22 financial statements. But it's absolutely part of

1 the financial reporting process and integral to it.

2

3 To my knowledge, there's no requirement for a
4 public company to actually publish an earnings
5 press release prior to the filing of their 10-Q,
6 although that is practice for most companies. And
7 I could easily see a standard being written that
8 said, in the case where a public registrant
9 publishes a press release as part of its financial
10 reporting process, that the auditor must read it at
11 a minimum. The baby step would be read it for
12 material inconsistency. If you want to go past the
13 baby step, there's not a standard for the
14 preparation of earnings press releases as there is
15 with MD&A, where you can provide an attest report.

16

17 But as the concept release also points out on
18 page 24, there are three things that an auditor
19 opines on when they attest to MD&A. The one that I
20 think would be lacking for press release would be
21 that it's complying with certain published rules or
22 specified rules. But they could easily, I think,

1 get to the second two points, which is historical
2 information has been accurately derived out of
3 historical records of the company, and that maybe
4 negative assurance, possibly, on nothing came to
5 their attention that the underlying information,
6 the termination estimates, assumptions, that the
7 entity provided are not reasonably supported or
8 that there's not a reasonable basis for the
9 disclosures contained.

10 Auditors do have experience in being involved
11 with statistical data when they issue comfort
12 letters to underwriters. They have the ability to
13 make reasonable determinations and reporting as to
14 whether things are misleading, including
15 statistical data being used that could be
16 misleading. And we could pursue auditors being
17 associated with, or at least involved with, maybe
18 not providing assurance on, but if the standard
19 required involvement with that data, and that the
20 public was then made aware that the auditors do
21 include some procedures on that data, I think it
22 might run to Mark's objective of having, maybe not

1 assurance, maybe not direct assurance to the
2 investor, but at least knowledge that there was
3 involvement with the data that was published by the
4 company, and that that data is much more timely
5 than what is coming either in the 10-Q with or
6 without a limited review report, because I would
7 also point out that limited review report is
8 boilerplate. It's not tell you anything.

9 And we all know that the limited review has to
10 be done, so to me it's not important to publish a
11 limited review report. You just know that if you
12 are a registrant, you have had that review done.

13 So I just think that there is opportunity here
14 to pursue involvement with, but I'm hesitant to go
15 as far as trying to define assurance on press
16 releases.

17 Obviously, this also gets into cost and time
18 constraints. You're in a very constrained, tight
19 closing cycle. But I think it's possible to have
20 the auditors have involvement with the press
21 releases that should not be inconsistent with the
22 subsequently filed Qs or Ks.

1 MS. WATTS: Jay Hanson?

2 MR. HANSON: I want to react to a couple
3 things that the two Garys have said, and Alan
4 Beller mentioned it as well, and maybe just pose a
5 question, and a little bit of a surprise.

6 Gary Kabureck opened up the day with the
7 question of who are the financial statement
8 preparers writing the financial statements for, and
9 who are the auditors reports directed at. And Alan
10 said succinctly that it's not for Aunt Mabel; it's
11 for the sophisticated investors. And so we have to
12 assume some level of knowledge.

13 And, Gary, when you mentioned a little bit ago
14 about that one cent differential in the earnings
15 and how much the markets move on that, if they're
16 missed by a penny. And I know that is reality.
17 That happens a lot.

18 But unless you're looking at Joe's
19 Barbershop's financial statements, which there is
20 probably not a lot of subjectivity in the numbers
21 in those financial statements, almost every
22 sophisticated business today, as well as the larger

1 financial institutions, there's a lot of squish in
2 almost every number on those financial statements.

3 And it would surprise me if a sophisticated
4 analyst wouldn't appreciate that.

5 And I realize that Larry Smith is here as a
6 representative of the FASB. And they have been
7 working really hard on trying to get that more
8 transparent in the financial statement for years
9 with the leveling of the fair value measurements,
10 as well as the disclosure proposals about the
11 sensitivity and the measurement uncertainty. But
12 even without specific discussion of this given
13 number could vary by this many dollars, given the
14 substantial improvement in disclosures over the
15 last couple years, I would think that it shouldn't
16 be any surprise to any sophisticated investor that
17 there's just a lot of latitude in a lot of the
18 numbers, the larger the financial institution
19 becomes, and the more fair value measurements are
20 in the financial statements.

21 MS. WATTS: Brian Croteau?

22 MR. CROTEAU: Thanks.

1 Actually, Larry, I'm glad you raised the point
2 about there not being a requirement around earnings
3 releases. Really, the question to pose relative to
4 that point, I guess one is whether we see problems
5 today where companies are re-issuing earnings
6 releases on a regular basis, such that there needs
7 to be some mandate for auditor involvement. And
8 then secondly, I guess there'd be some requirement,
9 presumably, that the auditor finish their work on
10 the earnings release before the press release could
11 be issued.

12 And I won't sort of get into the points around
13 authority and whether the SEC would take up that
14 kind of project, but I guess I just wanted to
15 understand sort of the impetus and whether we're
16 seeing a problem with the quality of earnings
17 releases today that people are trying to address
18 with this point.

19 MS. WATTS: Chris Spahr?

20 MR. SPAHR: As a sell-side analyst, timeliness
21 always matters the most to me. And so I would
22 think anything that would push out the earnings

1 release is actually detrimental to the investment
2 process.

3 Secondly, how I view the auditor work is I
4 want accuracy and quality, and I don't know if
5 looking at the sufficiency or the accuracy of an
6 earnings release is actually going to give me
7 greater confidence in the underlying marks or the
8 accuracy of the low-loss provision. So I'm afraid
9 that if you focus on the earnings release, you're
10 going to get away from what we want the auditor to
11 do, which is look at the quality of the financial
12 statements. And that kind of goes back to the
13 first two points, not to this third point.

14 MR. BAUMANN: I just want to understand your
15 comment on accuracy, because that's not a word that
16 goes particularly well with a set of financial
17 statements, in my view anyway. And I think it was
18 the point Jay was making.

19 Financial statements are nothing but a mass
20 amount of estimates and judgments, allocations of
21 cost for periods.

22 And they're anything but accurate. They are

1 based upon the assumptions and estimates used by a
2 company, hopefully prepared consistently, such that
3 that the numbers present reasonably.

4 Is there any difference of view on that point?

5 MR. SPAHR: No, actually. I think accuracy
6 would be the granularity of the quality of
7 disclosures and what the exposures are.

8 I cover financial institutions, so to the
9 extent that I know what the puts are for mortgage-
10 backed CDOs in November 2007, some of that didn't
11 come to light in July of 2007 earnings release, and
12 it wasn't in the Qs following that.

13 And again, so it wasn't in the Qs, which was
14 in theory reviewed by the auditors. It wasn't in
15 the earnings release. So it was more of a
16 qualitative point on that. Do we have the full
17 amount of information that we need to make a good
18 investment decision?

19 So again, it comes back to, is there
20 sufficiency in the audit review process, and making
21 sure that investors have all the information they
22 have.

1 I'd rather judge management on the earnings
2 releases, and then judge auditors on the quality of
3 the Qs and Ks.

4 MS. WATTS: Sam Ranzilla?

5 MR. RANZILLA: I think it's fairly clear,
6 based on my comments earlier this morning, that as
7 it relates to the attestation of a portion of MD&A,
8 I think that is a short-term solution to the
9 issues. And I note that others in the room have
10 stated they don't.

11 I vehemently disagree with that position. And
12 I think if you look at what the CAQ has crafted out
13 for a sliver of MD&A, I think it addresses the
14 kinds of issues that have been raised.

15 I also agree with the context that today a
16 full attestation of MD&A is not cost-justified.
17 That's what we heard when we talked with investors.

18 I think others have said that as well.

19 But I do think, from a short-term perspective,
20 critical accounting estimates is a place where this
21 board should look for -- at least pursue further a
22 potential solution.

1 I would also suggest that the rest of this
2 section dealing with other information outside of
3 the financial statements is better left to a
4 second, separate project, because -- taking
5 earnings releases as an example. I mean, just
6 think about what we just heard is all the
7 challenges are to an auditor association with
8 earnings releases beyond what it is today.

9 So when I say association that
10 means some form of reporting to somebody who's
11 going to rely upon it beyond either management or
12 the Audit Committee. So the challenges around
13 earnings releases -- one, there's no framework for
14 which an auditor to assert to.

15 Bob Kuepper's point of he maybe agreed upon
16 procedures as a place where we could provide some
17 value but today we'd have to rewrite the rules
18 because agreed-upon procedures reports can only be
19 shared with, in essence, internal people or people
20 that signed our engagement letter that says, do
21 those procedures.

22 Somewhere that would have to be something like

1 the SEC would designate the agreed-upon procedures
2 and then the report could be issued as a standard
3 form.

4 The third piece, and the piece that I have
5 struggled with on whether it's a quarterly earnings
6 release or an annual earnings release, is maybe
7 absent agreed-upon procedures effectively what the
8 auditor would be doing is reporting on work in
9 process.

10 We're not done the audit -- we're not done the
11 quarter -- the interim review at the time the press
12 release goes out. I think how does an auditor
13 report on work in process -- something, quite
14 frankly, that we've struggled with a bit on comfort
15 letters where we're in the middle of -- you know, a
16 deal gets done after the press release goes out but
17 before the 10-Q is issued, and that has always been
18 a challenge for us and that's just an agreed-upon
19 procedures report.

20 So I think the whole area of non-GAAP and
21 earnings releases are things where maybe the
22 profession can place some value.

1 I just think you ought to carve those out and
2 look at that as a different element of this project
3 because I think the amount of time it would take
4 and maybe to Lynn's point the willingness of the
5 marketplace to absorb that additional cost is a
6 longer-term project than the more immediate issue
7 of improving the reporting model for the auditor
8 today. Thanks.

9 MS. WATTS: Steve Buller.

10 MR. BULLER: Just a few brief comments. I
11 just struggle with whether we're proposing a
12 solution in search of a problem here, especially
13 with respect to interim reporting. I mean, the
14 auditor for us is involved in reviewing our
15 significant transactions on an interim basis and
16 reading our 10-Q and reads the earnings releases.

17 But they really are focusing on pieces of the
18 entire operation, and certainly they're in no
19 position to make any assertion on the overall
20 quality of information or on the fairness of
21 presentation. So although people would hate to
22 have it characterized as such, it reacts as a

1 detect type control for management, and I think
2 they'd feel comfortable reporting upon anything --
3 any association with the financial statements other
4 than perhaps a type of agreed-upon procedure.

5 With respect to the year-end reporting on the
6 activities they perform with respect to the MD & A
7 and other information contained in reports
8 containing financial statements, I think that
9 perhaps can be clarified, as we'll probably discuss
10 next in the auditor's report, as opposed to
11 requiring a further set of procedures over their
12 function.

13 MS. WATTS: Flerida Rivera-Alsing.

14 MS. RIVERA-ALSING: Thank you. One thing --
15 assurance on certain information is not a matter of
16 whether we trust the management or we trust the
17 Audit Committee of the company. I think, as former
18 President Reagan said, trust and verify, and we
19 look at the auditors to do the verification on
20 behalf of the investors.

21 Saying that the auditors are involved in the
22 process is enough, I think, is incorrect because

1 that will give us a false sense of security on
2 those numbers that are being released quarterly
3 under earnings.

4 And then discussions about who are the users
5 of the financial statements. Some says -- some say
6 only the sophisticated investors. I totally
7 disagree. I think it should be the reasonable
8 investors. Thank you.

9 MS. WATTS: Okay. We'll take Bill Clark and
10 then Charles Elson. Bill?

11 MR. CLARK: Yeah. Just -- I think I basically
12 agree with what Steve from BlackRock said. I mean,
13 just from talking to other pension managers and
14 being in groups that represent funds, I think in
15 the abstract most investors would say everything up
16 on that screen is fantastic and is something we
17 should strive for.

18 But practically, I can't say I've ever talked
19 to anyone who would put that near the top of a list
20 of things that they would want to see in terms of
21 improved governance in financial reporting.

22 And maybe it's because of the cost

1 justification. Maybe because there are just other
2 issues that are more important. I just -- I just
3 don't see this burning need or desire on the part
4 of investors to make this a priority item.

5 And then you kind of link it back to Lynn's
6 comments to the extent political capital would have
7 to be used to get something like this done, I think
8 I would probably agree we'd rather it be used
9 elsewhere.

10 The other point on the earnings releases, I
11 would say more often than not the things that move
12 the market the most are the forward-looking
13 statements which wouldn't be subject to review
14 anyway.

15 So I'm not -- and again, maybe that just gets
16 to the point in terms of how much value -- is it
17 relative to the cost and the impact on time in this
18 because I agree with that as well.

19 When you get to the fifth business day and
20 Alcoa is not out there with their earnings results,
21 I think you'll see some reactions from investors.

22 MS. WATTS: Charles Elson.

1 MR. ELSON: I think there are certainly
2 portions of the MD & A that the auditors could give
3 an assurance on. The problem is once you move
4 beyond the financials and you move way beyond the
5 financials, there's a real slippery slope, I think,
6 involved that once they are asked to provide
7 assurance outside of the financials into other
8 areas there's the danger that they'll be called
9 upon to begin to offer expertise or insurance on
10 all kinds of things, once you go through that --
11 you break through that line, if you will.

12 I mean, I've always, you know, wanted to be a
13 fighter pilot but I can't see beyond my nose and,
14 you know, there are certain things that I'm not
15 good at. I can't repair plumbing and, you know, I
16 can read a law text but that's where I need to
17 stick to my business.

18 And I think that if you take them outside of
19 the area which they have traditionally had
20 expertise and knowledge, even if it looks a little
21 bit like outside of that area they have some
22 expertise, it's a real slippery slope.

1 Once you do that, then there will be pressure
2 then to go beyond that and they effectively become
3 this sort of uber monitor of the corporation, and
4 that's not what they were set up to do.

5 MR. BAUMANN: Thanks, Charles. Sam, I'm going
6 to ask a question -- if you can't answer it or if
7 Bob or one of the others from the firms want to
8 take a shot or don't want to answer it -- but Lynn
9 made a point before of what's politically possible
10 in this -- at this particular point in time and was
11 talking about this area of providing expanding
12 auditor responsibility to cover, for instance,
13 critical accounting estimates.

14 They may not politically feasible and I guess
15 mainly because he was talking about cost, I think.

16 From your perspective -- and if you don't have
17 a view, fine -- would the AD & A be -- what's the
18 relative costs of auditor reporting in an AD & A
19 format versus auditor reporting on critical
20 accounting estimates?

21 MR. RANZILLA: Well, let me -- let me reply on
22 behalf of Bob Kueppers and Deloitte & Touche.

1 Marty, this is just my view and this is something
2 that we have talked about. I believe it is -- it
3 will be more costly to do an attestation of
4 critical accounting estimates than it will be to do
5 some form -- a form of AD & A that is very close to
6 what's included in the concept release.

7 So I do think it is. Others might have a
8 different view. But I will tell you I think the
9 risk of affecting filing deadlines is more
10 significant for an AD & A than it is for an
11 attestation of critical accounting estimates
12 because while MD & A is usually prepared later in
13 the reporting cycle, it's also something that we
14 can continue to do work on over -- first of all,
15 it's objective in terms of you've seen the report,
16 does it comply with SEC standards, where an AD & A
17 is going to go through multiple reviews internally
18 -- it's going to go through multiple reviews at the
19 company, at the company's counsel, at the Audit
20 Committee, at the Audit Committee's counsel.

21 And I think an AD & A has a higher risk of
22 slowing down financial reporting even though it is

1 marginally less costly than an attestation of MD &
2 A. That is one man's view.

3 MR. BAUMANN: All right. Thanks, Bob. Lynn,
4 is your card up on this topic? Okay.

5 MR. TURNER: Yeah. Also speaking for Bob
6 Kueppers, I'd probably beg to differ with Sam on
7 the -- the critical accounting policies, when I've
8 gone through and I've done this here recently,
9 looked at them and compared them to what their
10 auditor is already reporting on in terms of the
11 accounting policies back in the financial
12 statements, there just isn't that much difference
13 these days, quite frankly, and in fact in some
14 cases you actually see more and more robust
15 disclosures back in the actual footnotes.

16 So I would be shocked or surprised if it cost
17 me more to get an audit report and assurance on the
18 critical accounting policies than it would be to do
19 a separate AD & A.

20 Having gone through and done MD & As and
21 knowing the process that we've gone through to do
22 that, I think there would be levels of review.

1 It'd take you more time -- not a lot more time
2 because keep in mind you have to have that
3 completion memo done by the time you sign off on
4 the financials and get to the report date, and most
5 of what you're going to write about would be at
6 least in that completion memo anyway, which the
7 partner -- concurring partner -- and if it has to
8 go up the ladder that already has to be signed off
9 on -- and so I think the AD & A would have
10 additional cost.

11 Do I think it would slow things down that
12 much? No, since I don't believe we're asking the
13 auditors to do any more audit work.

14 What we're telling -- asking them is to tell
15 us what they know from the audit work they've
16 already done and they already have to capture that
17 in that completion memo.

18 I don't think it should be significant
19 additional cost, and if you do it on a fairly
20 limited basis along the lines of what Alan Beller
21 was suggesting I think there should be some
22 additional cost and reimbursement but I don't think

1 they'll be that significant. But that's just
2 talking for myself.

3 MR. BAUMANN: Thanks, Lynn. All right. I
4 think we have Bill Clark, Sam Ranzilla -- still up,
5 Sam? Bob Kueppers to probably speak for himself,
6 and Mike Gallagher.

7 MR. KUEPPERS: I don't -- I don't agree with
8 Bob Kueppers.

9 [Laughter.]

10 MR. KUEPPERS: Either one of them.

11 MR. BAUMANN: Does that often happen to you?

12 [Laughter.]

13 MR. KUEPPERS: Here's the truth. Sam's right.
14 We talked about it. But what he said that I -- I
15 just want to point out I think the critical
16 accounting estimates -- you know, attestation --
17 that's going to be about the work, less about the
18 report.

19 It just -- AD & A is all about the report and
20 I think -- I think there are additional costs but
21 it's because of the iterative process you're going
22 to end up going through -- certain amounts of

1 reviews.

2 But we don't have any data that would suggest
3 one versus the other. You know, Sam said marginal.

4 There's a cost but we have done no studies to
5 determine with any reliability the distinction
6 between the two.

7 MR. BAUMANN: Mike.

8 MR. GALLAGHER: Yeah, Marty. That's kind of
9 where I'm at. I mean, I honestly don't know. It
10 was interesting. Sam went one way, Lynn went the
11 other way. I'll say I don't know.

12 But don't underestimate the cost associated
13 with the level of review, and it's not as simple as
14 taking that completion memo and just publishing it.

15 At the levels of review that would be extensive.
16 And I'll just add to it, the other option -- the
17 emphasis of matter paragraph -- I would say out of
18 the three that's the least costly or and I would
19 say most cost effective, perhaps.

20 You could argue between whether MD & A or
21 whether that, but in terms of being able to do
22 something quickly and relatively inexpensively that

1 strikes me as something that would be the lower
2 cost alternative and maybe greatest value.

3 MR. BAUMANN: Mike, you began. You were one
4 of the two that began this discussion and Dan, is
5 your card up too? Oh, Florida. So Florida, why
6 don't I give you the floor and then Mike, I'll give
7 you the last word on this one before we turn to our
8 next topic.

9 MS. RIVERA-ALSING: Thank you. I just want to
10 agree with Lynn. I will be very shocked that the
11 assurance and critical accounting policies would
12 cost more than the AD & A. Currently, the audit
13 firms are already disclosing that and giving that
14 assurance to the Audit Committee.

15 MR. BAUMANN: Mike.

16 MR. COOK: Marty, I share that same view. I
17 guess if I were talking to a group -- a room full
18 of Audit Committee chairmen I would say to them
19 have a conversation with your auditing firm, your
20 lead partner, and ask them what it would cost to
21 report to you, perhaps -- might be the external
22 reporting -- we could think of that separately --

1 on MD & A, and if it's going to cost a lot then I
2 would be asking myself why is it that that isn't
3 being done today because this is critical
4 accounting policies, estimates, and judgments that
5 go into the preparation of the financial statement.

6 This is not new territory for the auditors.

7 Why would it take a great deal of effort to
8 give us a report on something that is so integral
9 to the financial statements? And if the answer is
10 it's going to cost a lot, maybe we ought to start
11 spending it because auditors aren't spending the
12 time with critical accounting policies, estimates
13 and judgments that they should be. I don't -- I
14 just don't know.

15 I just personally don't think this is a big
16 add-on, and the form of reporting that has been
17 suggested seems pretty reasonable to me.

18 Just a final thought on the overall
19 discussion. I think there -- you know, again,
20 there are things here that are a bit controversial
21 -- provocative, maybe, but also just thought
22 stimulating. But I do think we ought to -- and not

1 perhaps as a part of this specific project -- I
2 thought the notion of keeping these separate is a
3 pretty sensible thing because they're quite complex
4 and quite different.

5 But looking at the total financial reporting
6 process and who uses the results of financial
7 reporting and when is it used and how is it used
8 and where is the audit effort going, I'd like to
9 hear from the investor community.

10 What do they use to make investment decisions?

11 If their particular firm made a hundred investment
12 decisions or recommendations in a year, how many of
13 those are based on the annual financial statements
14 that we're going to do a lot potentially to change
15 in terms of the auditor's reporting on them?

16 How many of the decisions are made based on
17 those statements? How many decisions are made
18 based on quarterly earnings releases or Qs?

19 Take your pick. And ask yourself if we have
20 the cost of assurance attestation reasonably
21 aligned with the decision making that is resulting
22 from that. I'd kind of like to know because if

1 they make a hundred decisions a year and 94 of them
2 are made for reasons other than what's in the
3 annual financial statements, and Mike's point I
4 agree with -- the data which is driving that --
5 then are we spending all of what we're spending on
6 6 percent of the decisions that are being made and
7 is that a wise allocation of limited resources, and
8 maybe those resources should be reallocated.

9 The thing I think that comes up here is this
10 question about quarterlies and does it really make
11 sense not to have some form of auditor engagement
12 that reaches third parties.

13 If you stood back and asked the question would
14 the emphasis of matters make a whole lot more sense
15 if it was done on a timely basis instead of
16 emphasizing things next March that are relevant in
17 the second quarter of this year, and maybe that
18 ought to be integrated into the quarterly reporting
19 process, not into the annual financial statements.

20

21 Again, I realize the jurisdictional problems
22 of PCAOB and others and I realize the real-world

1 limitations that Lynn refers to, and I'm just
2 saying let's think about what matters, when people
3 get it and if we're going to fix things would it be
4 better to invest some of our resources in fixing
5 the things that matter the most instead of
6 continuing to shine the caboose. So I'll leave it
7 at that. Thank you, Marty.

8 MR. BAUMANN: Thanks, Mike. Sam, is your card
9 up again?

10 MR. RANZILLA: It is, if I might indulge you
11 one last time. First of all, I'd like to --
12 there's a difference between critical accounting
13 estimates and critical accounting policies. We, at
14 the CAQ's recommendation, is very specific to
15 critical accounting estimates.

16 The second point that I'd like to make for
17 your consideration is when you go back and read
18 what is required under the critical accounting
19 estimates for disclosure, I ask you to then try and
20 find those disclosures in today's MD & A.

21 And while I agree the auditor is all over
22 critical accounting estimates in determining

1 whether or not the financial statements taken as a
2 whole are fairly stated, I don't think there is a
3 significant amount of original work.

4 But the disclosures that are required under
5 that financial reporting release are fairly
6 extensive and will require additional work on -- if
7 not being done today on both behalf of issuers and
8 with auditors.

9 So I just ask you to look at that very closely
10 when you assess what all that would take and what
11 is the cost benefit around that approach.

12 MR. BAUMANN: Thanks, Sam. Lynn, is your card
13 up again or -- thanks.

14 MR. TURNER: Just one quick comment on the
15 issue of who are you doing these for, Marty, and
16 the reasonable or whoever the investor is -- Aunt
17 Martha or Uncle Lyle.

18 But another thing to think about there's a --
19 there's a study been completed by IBM by a person
20 who's now at State Street, and in that study it
21 demonstrates and finds that 85 percent of the
22 portfolio investment managers in this country

1 underperform just industry benchmark averages,
2 which leads you to believe that if you're indexing
3 with Fidelity or Vanguard you're probably well
4 ahead.

5 But 85 percent of the portfolio managers are
6 underperforming, and I'd have to think that there's
7 some group of those people who are underperforming
8 just because they don't know what they should know
9 and aren't doing their homework.

10 But I also think that a piece of that
11 underperformance is they aren't getting the pieces
12 of information that they need, which is to Mark and
13 Michael's point about the reporting model. And as
14 you go and look through this, this is another
15 example of a situation where investors are saying,
16 we do need this additional piece of information.

17 And so if we're going to try to get it to
18 where these portfolios, which are so important to
19 Americans retiring now and to this country in that
20 respect, then we ought to really look at trying to
21 get those investors the information that they need
22 because the studies show that they aren't getting

1 it and they are seriously underperforming.

2 And if you got 85 percent underperforming,
3 that's a really serious problem. Eighty-five
4 percent of these people aren't dumb and aren't
5 incompetent. So I'd suggest you may want to go get
6 that study out of IBM and see if -- and/or talk to
7 the lady who did the study who's now at State
8 Street and see if there's some additional
9 information that came out of there that might give
10 you some tidbits on information that you could
11 require that would help improve that for American
12 investors.

13 MR. BAUMANN: I think I'd like to turn to the
14 very last subject. But Stephen, do you have one
15 more word on this?

16 MR. KOZERACKI: Yes. I just -- I was
17 listening to what Mike Cook was saying about, you
18 know, the timeliness and the importance of the
19 quarterlies and, I mean, I think he is correct and
20 that probably a lot more decisions get made based
21 on the quarterly information.

22 But I think one of the differences is that,

1 you know, most large public companies, after they
2 release quarterly information, you know, the
3 analyst community and investors have, you know,
4 access to management for anywhere from, you know,
5 45 minutes to a -- maybe up to an hour and a half
6 and, you know, you have sort of an entire group of
7 educated investors and analysts who are sort of
8 able to pepper them with questions and ask them,
9 you know, a lot of detailed questions about, you
10 know, perhaps how some things -- businesses perform
11 during it and maybe even get some outlook on, you
12 know, what's happening in the current quarter.

13 And so I think, you know, investors get some -
14 - more comfort from that, and then also there's
15 transcripts from those calls that allow the
16 investors to review that as well. And I'm not sure
17 they would want to give that up or the timeliness
18 they get from the earnings release with the follow-
19 up call with the -- with management just to get,
20 you know, something that says, you know, we
21 reviewed the earnings release and it, you know,
22 appears to be accurate.

1 So I think there are more decisions from the
2 quarterly information but I think it's as much
3 based on the follow-up conversations with
4 management and the investor calls rather than, you
5 know, what's being attested to that the quarterly
6 release is accurate.

7 MR. BAUMANN: Thank you very much. Well,
8 turning to the last subject, Jennifer Rand does a
9 lot of extraordinary work in the Office of the
10 Chief Auditor and she will miraculously cover the
11 last hourly topic in the next 30 minutes.
12 Jennifer?

13 MS. RAND: Thanks, Marty. Okay. We're in the
14 last section of talking about alternatives in the -
15 - to the audit -- changing the auditor's report.
16 This section will cover both clarifying language in
17 the standard auditor's report as well as other
18 alternatives that weren't described in the concept
19 release or could also be a combination of the
20 alternatives.

21 Going to the clarification, when we did --
22 when we did our outreach -- and a lot has been

1 talked about the outreach we performed, which
2 really helped inform our views on the concept
3 release -- we did hear that while the current
4 report is boilerplate, there would be some benefit
5 to enhancing that quote, unquote, ``boilerplate
6 language'' to better describe what an audit is and
7 what an audit represents.

8 Many in our outreach said that would be a cost
9 effective way to making some changes and there
10 could be some benefits to doing so because there is
11 some confusion about the auditor's responsibility
12 over certain information like other information and
13 other matters.

14 So certain other topics, and this list is not
15 all inclusive, but it would be describing what's
16 meant by reasonable assurance, and an auditor's
17 report provides reasonable assurance that the
18 financial statements are fairly presented.

19 So some have said it'd be helpful if the
20 report described what reasonable assurance means.
21 Another area is the auditor's responsibility for
22 fraud. The auditor's report today does not

1 describe what that responsibility is and some said
2 it would be helpful if it did.

3 Another is the auditor's responsibility for
4 financial statement disclosures. The financial
5 statements include balance sheet, income statement,
6 cash flow as well as the notes to the financial
7 statements, and some have suggested perhaps it
8 would be helpful if that was mentioned in the
9 report.

10 Another is management's responsibility for the
11 preparation of the financial statements. There's a
12 sentence in the report today that says the
13 financial statements are the responsibility of
14 management but some have said it would help if it -
15 - if there was better clarification that management
16 is determining estimates and judgments and then the
17 auditor's responsibility is to issue an opinion on
18 those financial statements. So what goes into the
19 preparation of the financial statements.

20 Another is the auditor's responsibility for
21 information outside the financial statements, so MD
22 & A. For example, we just talked about should

1 there be greater assurance and we've talked about
2 that auditors read MD & A for material
3 inconsistency.

4 But the auditor opinion doesn't tell you that,
5 and from what I heard from comments in the last
6 section some think that auditors do a lot and
7 they're all over it, as one person said, and others
8 indicated well, they do a lot but it is limited to
9 reading and so forth.

10 It doesn't go into all the things that's in
11 the attestation report that exists but currently
12 many auditors are not engaged to do those type of
13 assurance reports.

14 And another possible area is auditor
15 independence. The title says it's the independent
16 auditor's report but some have said it'd be helpful
17 to know more about auditors' independence -- if
18 there's any potential issues discussed with the
19 Audit Committee and have that brought forward in
20 the auditor's report.

21 So the questions we're asking in that area
22 include would these potential clarifications serve

1 to enhance the auditor's report and help readers
2 understand the report, the auditor's
3 responsibilities, why or why not; what other
4 clarifications or improvements could be made to
5 better communicate the nature of an audit.

6 I said that the list I just went over was not
7 all inclusive. There's others. And then what are
8 the potential benefits and shortcomings to
9 providing clarifications in the report.

10 And then also in this section I want to cover
11 other alternatives. So what alternatives or are
12 there any other alternatives that the Board should
13 consider as far as changing the auditor's report.
14 Would a combination of the alternatives that we've
15 discussed today or presented in the concept release
16 be more effective, so are you supportive of
17 emphasis plus reporting on MD & A or something like
18 that, and which alternative is the most appropriate
19 and why.

20 So with that, I'm going to open up the
21 discussion to both talking about clarification and
22 other alternatives and we will effectively do that

1 in now 25 minutes. So I open the floor up for your
2 comments.

3 MR. BAUMANN: Things we are particularly
4 interested in, as well as the commentary on
5 clarification, are the things that we haven't
6 thought about that we're not yet -- that weren't
7 put in the concept release that somebody here
8 thinks this is another good way to deal with
9 clarifying or improving the auditor's reporting
10 model, as Jennifer said.

11 MS. YERGER: Well, it's hard to say you oppose
12 a clarification because by its very nature, I mean,
13 everyone wants things clarified. I think -- when I
14 see the long laundry list I get concerned that one
15 of the primary benefits of that -- the current
16 pass/fail report is its brevity and you add a lot
17 of legalese, which I think a lot of this would be.

18

19 I don't know if that's a good thing. So let
20 me just comment on two clarification/enhancements
21 that were part of the Treasury Department's
22 Advisory Committee on the Auditing Profession --

1 the ACAP, as we lovingly called it -- I was on that
2 committee -- and I think they should be considered.

3 One has to do with the auditor's
4 responsibilities regarding fraud, and we talked a
5 lot in that committee about that expectation gap
6 and our feeling was that the biggest expectation
7 gap was about what's the auditor's responsibility
8 when it comes to detecting fraud.

9 I think it's shocking, in a way, that the
10 auditor's report doesn't even mention fraud, and
11 the auditing standards do currently require the
12 auditor to plan and perform the engagement to
13 detect material misstatements whether caused by
14 error or fraud, and I think that does need to be
15 explicitly placed into the auditor's report.

16 The second item, which might be dubbed in the
17 more provocative area and it's certainly an
18 enhancement and not a clarification -- is -- and it
19 was something that was discussed quite a bit at the
20 ACAP was the addition of the name/signature of the
21 audit engagement partner on these reports.

22 I don't think anything sharpens the mind more

1 than placing a name on something and we think that
2 would be a very important and valuable addition to
3 the current report.

4 MS. RAND: Thank you. We do -- just on the
5 second point regarding the name, we do have a
6 separate project looking in that -- at that. So
7 that's very active. I'm involved in that one as
8 well.

9 This audit report is looking at the content --
10 what should be in the report. That other separate
11 project, which is actively moving forward, goes
12 into who providing transparency and to who. Is
13 that Charles Elson or -- no, totally wrong.
14 Sorry.

15 MR. SANTAY: Mike Santay.

16 MS. RAND: Michael. Sorry.

17 MR. SANTAY: Yeah. That's okay. Just a
18 couple of brief comments. Generally, we support
19 the changes that are outlined and some of these,
20 you know, I think there could be some alignment
21 with some of the proposed standards. For example,
22 the International Standards on Auditing have

1 addressed some of these matters and I think would
2 be helpful to look at that as part of these
3 considerations.

4 And then just, you know, operationally -- for
5 example, if we were to add something around other
6 information -- you know, reports get reissued,
7 consents get used -- the other information might
8 change. Just so from an operational perspective
9 just be careful with how much detail we get into or
10 specificity in some of these additions if the Board
11 decides to move forward with some of these
12 recommendations.

13 MS. RAND: Thank you. Mark Newsome.

14 MR. NEWSOME: Thank you. You know, the first
15 thing is, you know, if you're going to expand the
16 form in a boilerplate fashion I'm not sure that
17 would be all that helpful.

18 I would encourage auditors to differentiate
19 themselves with the letter -- make it more like an
20 opinion that you might see in other situations.
21 But with regard to the audit opinion itself, I
22 would encourage you to include a negative assurance

1 clause.

2 We often ask that of auditors in private
3 investment transactions where the auditor will
4 actually send us a letter, we're not aware of any
5 defaults or other things that might cause you to be
6 concerned or might cause a default in your own
7 investment structure. I think that would be very,
8 very helpful and something that people often want
9 to see.

10 MS. RAND: The auditor's opinion is reasonable
11 assurance (inaudible) higher than negative
12 assurance unless you're looking for a particular
13 negative assurance on particular items because the
14 opinion goes as a whole -- the financial statements
15 as a whole.

16 So are you looking for certain specific --

17 MR. NEWSOME: Right. I'm not looking for a
18 lower level of assurance and so what I'm talking
19 about specifically is a statement, we are not aware
20 or have not become aware of any defaults or fraud
21 or other matters, you know, in the opinion itself.

22 That's something that we ask for from auditors

1 separately from their opinion.

2 MS. RAND: It looks like I have the order down
3 in a row. So Gary Kabureck and then Mark LaMonte.

4 MR. KABURECK: Thank you, Jennifer. Just a
5 couple of quick comments in here. In terms of
6 other alternatives, one thing you might consider is
7 in the auditor's end report the role -- their
8 involvement with unaudited statements, and you got
9 a unaudited quarterly data footnote. I mean, it --
10 you've got some other unaudited, you know,
11 subsequent events footnotes.

12 Maybe there's some other special industry
13 disclosures that are unaudited. So what -- so
14 these are annual financial statements. I mean,
15 they're -- when they're filed they're covering
16 stuff at least 14 months earlier.

17 So what's their involvement or responsibility
18 for the unaudited data in their -- I'm thinking
19 quarterly or subsequent events but maybe there are
20 some other things -- again, just clarifying
21 responsibilities that your work extends to the
22 annual statements and not to the interim.

1 Now, maybe you got to clarify and say we've
2 done reasonable procedures or something that goes
3 back to the rest of the stuff about what else would
4 you opine on. So there's that on the unaudited and
5 the interim.

6 I think if you're going to pick one thing off
7 this list I would say it's the responsibility for
8 fraud whether -- either what the current
9 responsibility is or what the (inaudible) may
10 choose that should be in the future.

11 And then lastly, you know, Ann's point -- I
12 absolutely personally agree with putting the
13 auditor's -- signing engagement partner's name in
14 the report, and I know we've discussed it several
15 times at SAG and the PCAOB has done many times and
16 you've heard me say more than once in this forum.

17 We've spent a lot of time on it. It's time to
18 just give it a thumbs up or thumbs down vote, in my
19 view. But since my own name is the releasing
20 officer's in there I see no reason, you know, why
21 the firm couldn't be there too.

22 I do appreciate you've hired the firm, not an

1 individual. But nonetheless, these are Xerox's
2 financial statements, in my case, but they are
3 going out under my signature so --

4 MR. BAUMANN: You're endorsing the signature
5 concept. Thank you.

6 MS. RAND: Okay. Mark LaMonte.

7 MR. LAMONTE: Thanks. Looking at your laundry
8 list, I do see value in an investor knowing more
9 about many of those things and the auditor's
10 various responsibilities and the limitations
11 thereof.

12 The concern I have about this or the thought I
13 have about this is that you're just going to
14 probably get very standardized language that will
15 be the same from report to report depending on who
16 the signing firm is.

17 So an easy way to address this or a way to
18 address this more efficiently where you're not, you
19 know, just increasing the forest for the trees
20 problem we already have with very long annual
21 reports is just include a Web link in audit
22 opinions. It takes you to the firm's website where

1 all of these things are described.

2 Beyond that, the one that could be unique for
3 --from company to company is the discussion of
4 auditor independence and issues affecting auditor
5 independence.

6 Quite honestly, I would be surprised if
7 investors are ever making investment decisions
8 based on a view of whether or not they think an
9 auditor is more or slightly less independent. So
10 I'm not sure adding much on that in an opinion
11 really would add value for investors.

12 MR. BAUMANN: On the point that Mark just
13 made, Mike, or someone else, maybe you could help
14 me. The U.K., I think, has that requirement today,
15 don't they, where there's the opinion but there's a
16 link to some of this other information about the
17 audit. Do you know if that's accurate or not?

18 MR. GALLAGHER: Yeah, I think that is. I think
19 that's -- you know, we'd certainly be, you know,
20 very interested in looking -- certainly would have
21 no objection to looking at that, Marty.

22 MS. RAND: Mark, just to follow up on your

1 point about independence, in our outreach one of
2 the -- I guess another reason that was cited that
3 it might be helpful just to at least have a
4 statement in the opinion for the auditors to
5 reaffirm their independence. The title says
6 independent auditor's report but if they sign off
7 every year, yes, and we are independent there might
8 be -- some perceive there might be some benefit to
9 that.

10 MR. LAMONTE: I don't think a brief statement
11 would hurt. I think that'd be fine. An extensive
12 discussion, however, would not add value.

13 MR. BAUMANN: Well, the auditors are also
14 required to report to the Audit Committee of
15 matters that might be thought to bear on
16 independence, such as if they had an independence
17 violation during the year what that was and why
18 they believe that doesn't affect their
19 independence.

20 Do you think investors would benefit hearing
21 about the things that might be thought to bear on
22 independence -- that is, we found out that our

1 manager owns some shares of stock and we replaced
2 him or her and reaudited the area they were
3 responsible for, and therefore we believe we can
4 continue to express an opinion. Would that type of
5 information be of value?

6 MR. LAMONTE: Of all the things we talked
7 about today, I think that would be one of the least
8 influential on an investor's actual decision
9 making.

10 MR. BAUMANN: Thanks for that clear answer.
11 We got clarity around something today.

12 [Laughter.]

13 MS. RAND: Okay. Florida.

14 MS. RIVERA-ALSING: Thank you. Of all the
15 list that you have, there are three things that I
16 do support. The auditor's responsibility for fraud
17 -- I would like to know what auditors do to assess
18 the risk of fraud in the entities that they are
19 auditing, and then the auditor's responsibility for
20 financial statement disclosures.

21 On opinion page of the auditor's, they
22 referred to the financial statements as only the

1 balance sheet, the income statements and the
2 statement cash flows. Nothing is being said about
3 the notes to the financial statements, but really
4 the devil is in the details. If you read the notes
5 to the financial statements you will learn more
6 about the financials.

7 The third one is the -- is the auditor
8 independence. We hired a lot of auditors in our
9 organization and they do an extensive check on
10 whether indeed the entire audit firm is
11 independent, but I noticed that it is more
12 exhaustive when the entity that they are auditing
13 is a public entity.

14 But if it is a private entity they don't
15 really do a lot of -- I don't know, it's just my
16 impression. They do affirm to the Audit Committee
17 their independence and I do know that there are
18 discussions about it.

19 Whether that is valuable to the individual
20 investors or not, I think it is important for us to
21 know if there is a conflict of interest as far as
22 the auditors are concerned because we are relying

1 on their words but if there is a conflict of
2 interest should we rely on their words.

3 The fourth item that I do support is the name
4 of the engagement partner. I would like to know
5 who did sign the financial statements. Why should
6 it be a secret? It is known in the entire audit
7 firm. It is known in the company. Why should it
8 not be made public? That's all.

9 MS. RAND: Thank you. Jack Ciesielski.

10 MR. CIESIELSKI: Thank you. First of all, I'd
11 just like to point out, and maybe it's stating the
12 obvious, but this is a little different than the
13 other three areas that we discussed in the proposal
14 in that it's not really so much amplifying
15 information about the audit -- it's more or less
16 redefining the audit report.

17 Maybe I'm envisioning it wrong from the
18 concept release but I'm thinking that this would be
19 a revised standard opinion and the language
20 probably wouldn't change much from one company to
21 another or from one auditor to another.

22 But I think what we have heard today is that

1 there are different levels of knowledge of what
2 goes on in an audit by investors and there's
3 different levels of what investors -- knowledge of
4 what investors do by auditors.

5 But, you know, by having something out there
6 that more clearly delineates responsibility for
7 fraud, for disclosures, management's
8 responsibility, a statement of independence other
9 than just, you know, the one reference to
10 independence that we already have I think it would
11 be good.

12 You know, maybe it would be a standard rubber
13 stamp opinion but I think it would be a way of
14 educating some investors about what an audit does
15 or doesn't do, and I think if you have the
16 possibility of having to state something
17 embarrassing like what happened with our
18 independence during the year I think investors
19 indirectly benefit because I think firms would be
20 very much more on their toes about whether their
21 independence is impaired or the appearance of
22 independence is impaired.

1 So, you know, I don't view the clarification
2 of language section of the concept release as
3 anything that's, you know, earth shaking but more
4 or less, you know, clarifying what we've already
5 implied in the existing audit report. So that's
6 it.

7 MS. RAND: Okay. Thank you, Jack. Steven
8 Buller.

9 MR. BULLER: Thank you. We sat down with our
10 analysts and walked through these criteria, and it
11 was interesting because as you go through them one
12 by one you say, is it a good idea to put in
13 clarification on reasonable assurance and the
14 answer is oh yeah, it's a good idea.

15 And you go down to responsibility for fraud
16 and they said oh, that's a good idea too. And you
17 go through all of them and one by one they say, you
18 know, those are good ideas.

19 Well, then you say okay, so here's what the
20 opinion looks like, and they say oh, that's a lot
21 of opinion. And so you almost -- we sat down and
22 said let's talk about a Mazlovian hierarchy of

1 needs and what you think would be most important to
2 a user of financial statements -- what's least
3 clear right now -- and they said that probably the
4 auditor responsibility for information outside the
5 financial statements for them would be the one
6 thing which will be useful for clarification and
7 also the responsibility for fraud would be good
8 clarifications.

9 They thought that, consistent with our earlier
10 comments, auditor independence should be in an AD &
11 A section where it talks about auditor -- or an
12 auditor inputs being used, the procedures they're
13 performing -- belongs in that section.

14 They thought it was a good idea but not
15 necessary to include auditor responsibility for
16 financial statement disclosures and for preparation
17 of financial statements. They thought those were
18 pretty self-apparent.

19 But they would not -- we wouldn't object,
20 certainly, with support and inclusion of all these
21 in clarification somewhere. We just think that if
22 it's -- if these are all part of the ultimate

1 solution they probably belong in a separate and
2 subsequent paragraph or a long footnote somewhere
3 in the opinion so it doesn't overwhelm and
4 obfuscate the ultimate communication you're trying
5 to make about the auditor's conclusion on the
6 fairness and presentation.

7 MS. RAND: Thank you. Regarding
8 clarification, just a couple of thoughts. I see
9 clarification as having a couple potential
10 benefits. One, it really would add -- it would --
11 while it would add language to the standard
12 auditor's report, it could serve to help educate
13 investors -- better inform investors and other
14 users of the financial statements about what an
15 audit is and what it represents.

16 And another benefit I potentially see is, when
17 the auditors are signing that opinion, having the
18 auditor's responsibility stated in there for fraud
19 helps reaffirms that responsibility when they're
20 issuing the report that the auditor has done those
21 things, potentially. So I see those two potential
22 benefits.

1 I am very -- I don't see any other tent cards
2 up but I am very -- we haven't gone over my 30
3 minutes for this session. So I am interested if
4 others have any suggestions, thoughts for other
5 alternatives that we have not explored today.

6 I guess we -- oh. Is that -- oh, Joe
7 Carcello. Sorry.

8 MR. CARCELLO: This isn't really another
9 alternative, Jennifer, but it looks like we're
10 winding down and I wanted to get this in before. I
11 didn't know when you were going to kind of call
12 time here.

13 So it struck me that, really, this afternoon
14 was very different than this morning. I think the
15 last hour, although not unimportant, is -- clearly
16 is lesser importance than the three things we
17 talked about earlier today, and I think our
18 discussion about the MD & A -- I agree with Sam on
19 this -- it's a worthwhile discussion but it's
20 probably down the road.

21 I think the real issue for the Board is going
22 to be an AD & A and/or in emphasis paragraphs and

1 how those are implemented. And so I went back and
2 I looked at who we had here today and I -- if I
3 counted right there's approximately 32 folks here
4 today, not counting the Board and not counting
5 observers.

6 Sixteen of those people could be classified as
7 either direct investors or indirect investors or
8 investor advocates, and the other 16 would be
9 auditors, Audit Committee members and preparers.

10 And although those 16 auditors, Audit
11 Committee members and preparers are very bright and
12 very articulate and very well informed, the mandate
13 of the Board is very clear in the language that
14 Congress create -- used to create the Board and
15 that is to protect the interests of investors.

16 There's really no ambiguity about that.

17 And so with apologies to George Orwell, all
18 stakeholders are created equal but some
19 stakeholders are more equal than others, and I
20 would say investors are more equal than others than
21 the people here today.

22 So I tabulated where people stood on the AD &

1 A and versus an emphasis paragraph -- and I
2 encourage you and I'm sure you will go back through
3 the transcript and audit my representation here.
4 And so I'm going to go through this very quickly
5 and if I'm miscategorizing anybody I would ask that
6 they speak up, and this is in no particular order.

7
8 Steven Buller from BlackRock -- and this is a
9 direct quote -- ``AD & A could be useful'' and then
10 he kind of fleshed it out in a number of ways where
11 he thought it could be useful. Florida from the
12 Florida Board in favor of an AD & A; Steven from
13 Vanguard, AD & A would be helpful; Chris from
14 Credit Agricole endorse AD & A.

15 Lynn Turner favors AD & A; I favor the AD & A.
16 Ann Yerger favors the AD & A. Mary from CALPERS
17 wants an AD & A. Jack favors the AD & A. Kurt
18 wants the information from the auditor whereas less
19 important so I'm not sure how you classify him.
20 Paul from Capital Research, Matt from Fidelity and
21 Gary Walsh prefer the emphasis paragraphs.

22 Mark Newsome from ING, I couldn't tell -- he

1 never really explicitly stated it or if he did I
2 missed it. But he talked about due diligence
3 reports and how useful they were and it sounded a
4 whole lot more to me like an AD & A than an
5 emphasis paragraph.

6 MR. NEWSOME: AD & A.

7 MR. CARCELLO: I'm sorry -- AD & A. Mark
8 LaMonte from Moody's -- give firms an opportunity
9 to decommoitize their product. Again, I don't
10 know if he said it explicitly but I think they
11 probably have a better shot of doing that with an
12 AD & A than an emphasis, but that's my judgment.
13 And William Clark from the Federal Reserve, I
14 couldn't -- I couldn't find where he really
15 expressed an opinion on this.

16 So if I'm even close to right, there's 10
17 votes for the AD & A, three for the emphasis, two
18 no opinions and one no statement at all. If you
19 got that kind of vote on almost anything else in
20 today's society you'd have an overwhelming mandate.

21 MR. BAUMANN: Thank you and -- well, I was
22 just about to acknowledge you, Chairman Doty, but I

1 wanted to first thank the group for a tremendous
2 energy and participation today and throughout the
3 entire day.

4 I know it was a long day and throughout the
5 entire day everybody stayed committed to the
6 discussions and gave us a lot of important
7 information, and for that I thank you all very
8 much. And I would like to turn it over to our
9 chairman, Jim Doty, for final comments.

10 MR. DOTY: It struck me today how much this
11 resembled a real deliberation and not a polarized
12 debate. It is what regulatory administrative --
13 quasi-administrative bodies have to have.

14 When we started off this morning saying it
15 wasn't the last such discussion we're going to have
16 it certainly -- we may not have another roundtable
17 before the end of the year on this concept release
18 and on this issue but there are going to be other
19 discussions of this kind.

20 And I think you should be very proud of the
21 way in which you conducted the deliberation by
22 linking all of the important things you had to say

1 about the auditor reporting model concept release
2 to the bigger issues that relate to the future of
3 the audit profession, the welfare of shareholders,
4 the vitality of corporate governance in our
5 economy.

6 Listening to it, I think anyone who was
7 thinking about whether a process is moving in the
8 right direction would have been heartened and we
9 are deeply grateful for that and cannot conceive of
10 a better panel of expert opinion and enlightened
11 thought.

12 Lawyers always talk about leaving your
13 client's interest at the door. It never really is
14 possible.

15 But in this case, we're speaking with the
16 people who have the direct immediate interest in
17 the financial reporting model and its issues from
18 one vantage point or another, and you have managed
19 to articulate your own interest in it in an
20 enlightened self-interest way and in a way that
21 helps all of us get to a better understanding of
22 what each of us has to worry about.

1 We are deeply grateful to Martin Baumann and
2 the standards group of the PCAOB. They have worked
3 tirelessly and over the spring. This has been a
4 most arduous period for them.

5 Like the long gray line of Douglas MacArthur's
6 remarks, they have not failed us. They have never
7 failed us and they never will, and we thank you all
8 again for the support you've given them. You will
9 hear from all of us again. Thank you.

10 MR. BAUMANN: Thank you, and safe travels.

11 [Whereupon, at 4:59 p.m., the meeting was
12 adjourned.]

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