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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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THURSDAY
OCTOBER 2, 2014

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

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

2 9:47 a.m.

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

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

20 As you know, we benefit greatly at the PCAOB from
21 the advice we get from the Standing Advisory Group on all
22 of our various different issues and matters of standard

1 setting. And we look forward to these meetings and the
2 contributions that we receive.

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

11 Today's meeting is a bit unique compared to some
12 of our previous SAG meetings where we've covered a
13 variety of topics. Today, we're really focused on one
14 topic, one topic but one very important topic, and that
15 is the Staff Consultation Paper issued on August 19th
16 pertaining to auditing accounting estimates, including
17 fair value measurements. When you look at a set of
18 financial statements, it really boils down to a bunch of
19 accounting estimates and fair value measurements, so this
20 is really an important area of accounting and auditing
21 that needs the focus of our attention in making sure we
22 get this right in standard setting.

1 We've distributed the agenda, along with a copy
2 of the consultation paper, in advance of the meeting.
3 But these items are also included in the folder in front
4 of you. Hopefully, you've also all had a chance to read
5 the paper.

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

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

19 However, we also wanted to hold this meeting to
20 explore deeply the matters raised in the paper and engage
21 in a meaningful dialogue with this group on the need for
22 standard setting in this area, any new audit practices

1 that might be evolving around auditing estimates and fair
2 value measurements and a possible standard-setting
3 approach to respond to the need identified in the paper.

4 In developing responses to the paper, hopefully
5 commenters can take into account the various views
6 expressed around this table today to further inform their
7 thinking on the comments.

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

18 Now, this is important. As always,
19 notwithstanding the panel structure, we encourage SAG
20 members throughout the meeting at any time, including
21 during panelist presentations, to raise your tent card
22 on its edge and we'll make sure that we call on you and

1 get to your comments. So this is not about just hearing
2 presentations from the panels. It's a regular SAG
3 meeting. We want to make sure that SAG members have
4 input into the conversation at any time throughout the
5 day.

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

16 However, before recommending to the Board a
17 specific standard-setting proposal, we're conducting this
18 additional outreach through the Staff Consultation Paper
19 and this meeting to obtain information and views beyond
20 what we've learned from our earlier outreach or from the
21 Board's oversight activities. The outreach conducted
22 through the Staff Consultation Paper, including

1 discussions at this meeting and comment letters we
2 receive, should be invaluable in informing a potential
3 proposal of a new auditing standard.

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

9 So in that regard, let me make brief comments.
10 In thinking about potential revisions to our standards,
11 we've analyzed and continue to analyze a number of
12 alternatives. The alternative the staff is currently
13 presenting and discussing through the Staff Consultation
14 Paper could replace, is a single auditing standard that
15 could replace two existing standards entirely: AU 342,
16 auditing accounting estimates; and AU 328, auditing fair
17 value measures and disclosures; and replace certain or
18 all of the requirements in a third standard: AU 332,
19 auditing derivative instruments, hedging activities, and
20 investments in securities. These standards were all
21 written many years ago. As such, any new standard or
22 requirements could be specifically structured to be

1 further aligned with the Board's risk assessment
2 standards, auditing standard 8 through 15, which the
3 Board adopted in 2010.

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

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

22 As such, any new standard on estimates and fair

1 values could first be closely linked to the risk
2 assessment standards, which clearly direct the auditor
3 to properly identify and address these risks; and then,
4 second, set out further specific requirements unique to
5 the risks around accounting estimates and fair value
6 measures.

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

18 I must point out that these two substantive
19 procedures are in the existing standards today. But the
20 Staff Consultation Paper explores possible improvements
21 to them and addresses more specifically the role of
22 specialists and evidence obtained from third-party

1 sources. Most importantly, the paper seeks comment on
2 these procedures and asks are there alternative
3 procedures for the auditors to apply that we haven't
4 considered in this consultation paper?

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

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

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

20 MR. SCHILDER: Thank you, Marty. As the IAASB's
21 work in this area is mentioned in your paper, let me
22 briefly update the SAG where we might be moving. We have

1 a long history with this subject matter, certainly the
2 last ten years. And in 2007, the IAASB approved ISA 540,
3 and it's mentioned in your paper, auditing accounting
4 estimates, including fair value accounting estimates and
5 related disclosures.

6 Actually, that was a combination of two older
7 ISAs, one on estimates and the other one fair value
8 measurements. So we also took an approach of let's have
9 it all together.

10 That was 2007. Thereafter, we had to focus more
11 clearly on financial instruments, and that culminated in
12 the release of the so-called International Auditing
13 Practice Note 1000, Special Considerations in Auditing
14 Financial Instruments. That was 2011, and I know that
15 Greg Fletcher of the PCAOB participated in its task force
16 and reflect some potential enhancements to ISA 540,
17 certainly in the area of pricing services.

18 But in light of our other priorities and also the
19 upcoming project at the PCAOB will put us, at the moment,
20 on hold. We now will start a new period of new studies
21 and workplan, and so we've consulted on what we should
22 do and what our priorities should be. And there

1 certainly will be a project particularly relating to
2 financial institutions. That's an area of focus, of
3 course, for financial regulators but also other
4 respondents. So many have encouraged us to engage in
5 such a project.

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

13 Second, insurance industry issues, also areas
14 closely related to this topic and we will take that
15 onboard, as well. And then other 540 issues we will
16 consider there, the issues relating to ISA 540 that we
17 already would have identified as a result of work
18 regarding financial institutions and also more broadly
19 applicable to other entities. Such issues might include
20 application of professional skepticism, so how auditors
21 obtain evidence and challenge assumptions by management;
22 work on accounting estimates and fair values that have

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1 not been identified already as significant risks; fraud
2 and, certainly, also the implications of the use of
3 third-party pricing sources.

4 And that project, therefore, may result in
5 amendments to ISA 540, other ISAs, and maybe a new IAPN,
6 as well, practice note. And our first discussion in the
7 Board may be Q1 next year.

8 Now, just listening to this, it's easy to see
9 that there can be many areas of overlap between your
10 project, as identified in your excellent Staff
11 Consultation Paper, and our project, certainly a good
12 example is the area of third-party sources of audit
13 evidence. And, accordingly, the IAASB will be very
14 interested in exploring possible cooperation with the
15 PCAOB, and that can, of course, be done at various
16 levels.

17 We have some positive experience with that on the
18 auditor reporting project, and let me conclude with that,
19 given also the previous interest in the SAG, how the
20 IAASB was moving with audit reporting. I can report to
21 you, and it has not so much yet become public, that two
22 weeks ago the IAASB approved unanimously the new revised

1 audit reporting standards. And after the expected
2 approval by our public interest oversight board in
3 December, it will go public early next year and will
4 become mandated for 2016 audits.

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

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

20 I don't see any other cards up at this point, so
21 do we -- okay. So with that in mind, let's turn to the
22 first panel which deals with PCAOB and global inspection

1 findings.

2 The Staff Consultation Paper notes that audit
3 deficiencies in these areas have been noted not only
4 through the PCAOB oversight activities but also by
5 inspections conducted by other audit regulators around
6 the world. Our first panel will discuss in a bit more
7 detail PCAOB and global inspection findings in this area,
8 as well as the results of the past two surveys by the
9 International Forum of Independent Audit Regulators,
10 IFIAR.

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

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

22 Next to Brian, we have Jeremy Justin. Jeremy is

1 a senior director and leads audit inspections of CPAB
2 registered firms. He is also a member of IFIAR's
3 standards coordinating working group.

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

9 Helen?

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

1 accounts and, yet, has stumbled. And we have had
2 numerous findings in these areas.

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

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

20 And the first area that I would highlight is with
21 respect to hard-to-value financial instruments and, in
22 particular, audit work done on Level 2 securities, where

1 we have seen auditors struggle in their testing of these
2 securities, and their approaches might have been to take
3 a look at what the pricing service provided to the
4 issuer, compare that to the recorded balance and see that
5 they were close, and say that was good. However, the
6 auditor failed to understand the specific methods and
7 assumptions that have been used by the issuers' pricing
8 service in developing that fair value estimate; and,
9 therefore, that work was found to be deficient.

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

1 was found to be deficient.

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

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

17 Changing a little bit midstream here, accounts
18 receivable and the allowance for doubtful accounts. It
19 affects many, many, many operating companies, and this
20 is an area where we have also seen problems. One of the
21 problems that we've seen, and we've seen it occur with
22 some frequency, is with respect to the testing done on

1 the general reserve. And we've seen where the auditor
2 might focus their testing on a mechanical exercise of
3 proving that the general reserve percentage applied to
4 the aging buckets equates in a reserve balance that is
5 close to what is recorded.

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

13 So this was really a situation, and we've seen it
14 occur on more than one occasion, where the auditor is
15 deferring to what management has done and some perhaps
16 high-level view of this general reserve percentage is
17 consistent and, therefore, good. But that is not enough.
18 They need to understand and test that general reserve
19 percentage, as well as test the accuracy of the
20 underlying information used in the model that the issuer
21 has to come up with this reserve percentage. And testing
22 the underlying data that goes into some of these complex

1 calculations is a very important part of what the auditor
2 does, and it ties in also with some of the testing of the
3 computer-generated and IT type controls that are
4 associated with it.

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

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

1 of course, was problematic.

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

13 So all of those things have contributed to a view
14 that, you know, I think that there are real problems that
15 we continue to identify in this area. We focused on root
16 cause. We talked about that. I spoke about that a
17 little bit at our last SAG meeting. And we've been
18 focused on some of the times where we see auditors
19 getting it right, and two of the things that really stand
20 out are the sequencing of the work, the project
21 management type aspects where an auditor, an audit team
22 is doing the work at appropriate intervals in order to

1 be able to truly consider all the contrary evidence and
2 assess whether they are gathering enough information to
3 support their work and adequate supervision and review
4 where there is active and early engagement by the partner
5 in the work that is being done, appropriate coaching and
6 mentoring going on with respect to the audit work being
7 performed, in particular, in these very complex areas.

8 So, Jeremy, Brian, I think you guys have seen
9 some similar type of things, and I know you're working
10 on some other projects in this area. Let me turn it to
11 you.

12 MR. HUNT: I'm going to turn it mostly to Jeremy,
13 but this is clearly an area of great interest to us, both
14 from an audit deficiency point of view from our
15 inspections but also one of the things we've been working
16 on in Canada is greater guidance around 540 in terms of
17 how that standard needs to be implemented. We're working
18 with the standard-setters in Canada and the profession
19 to drive that forward.

20 So with that, Jeremy has worked extensively on
21 this, and I think he's the best to speak to that. So
22 it's a pleasure to be here, but I think Jeremy is our

1 man.

2 MR. JUSTIN: Thanks. And I think what we found
3 very much echoes what Helen had talked about. We
4 certainly look at audit estimates pretty frequently, and
5 we look at the focus areas from our inspections,
6 certainly the same areas that Helen had talked about
7 around estimates related to fair value, estimates around
8 impairment, good will, intangibles, certainly some areas
9 that we see quite frequently. As we see more and more
10 of the standards focusing more on fair values, we see a
11 lot more in a revenue recognition perspective. Long-term
12 contracts, fair values of multiple element arrangements.

13 So we're seeing it more and more. And as we
14 focus more on it, I think we're certainly seeing a number
15 of areas where the audit work has been done very well but
16 also still seeing a lack of consistency across all the
17 inspections we're looking at, as far as some audit teams
18 that are still having challenge and still struggling in
19 these areas.

20 So just to focus on a couple of the areas we're
21 seeing. I think, certainly, professional skepticism is
22 an area that Helen had talked about and it's across a

1 number of the different standards we look at and is
2 certainly a key area around evaluating conflicting
3 evidence, making sure that the auditor is not just
4 looking for information that supports what the management
5 has done but also having a dependent view.

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

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1 from more of an application perspective that teams are
2 having challenges with.

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

16 So the areas that we've kind of focused on are
17 kind of three main areas. The first one, obvious
18 professional skepticism around the evaluating evidence,
19 contradictory evidence specifically. The next one is an
20 area that Marty talked about was understanding
21 management's process and management's key assumptions.
22 I think we certainly see challenges still with audit

1 teams not getting a deeper understanding around how
2 management is making their estimates, and I think it's
3 an area that we think there could be some assistance,
4 more application guidance that auditors can use to help
5 them to evaluate management's processes and their key
6 assumptions.

7 And the last one is also around the area around
8 significant risks. ISA 540 has specific additional
9 requirements around, if something is considered a
10 significant risk,

11 there's additional work that needs to be done.
12 And I think it's very useful to have those procedures
13 done, but I think we still seem to have auditors
14 challenged with determining when an estimate is a
15 significant risk, when is there significant estimation
16 uncertainty that leads to a significant risk. So I think
17 we have encouraged to have more guidance out there to
18 help auditors evaluate when something is a significant
19 risk or not, and that helps to drive what procedures,
20 from a risk assessment perspective, in driving all the
21 procedures that they're performing. So I think that's
22 an area that we certainly think needs some improvement.

1 With that, I'll turn it over to Liza.

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

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

20 MS. MUNTER: I think I would link to something
21 that Marty said, which was wanting to link a new standard
22 to our risk assessment standards. And I think that that

1 is very important and would represent an improvement that
2 could drive an improvement in result in a higher-quality
3 audit.

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

10 MR. BAUMANN: Just one further thought, in terms
11 of its response to your question, which is a very good
12 one, Kevin, and one we're certainly thinking through to
13 make sure that standard-setting can help improve auditor
14 performance here. One of the things I heard from both
15 Helen and Jeremy was too often auditors, finding a piece
16 of evidence that supports what management has as its
17 estimate but not sufficiently thinking about or
18 addressing potential other evidence that might be
19 contrary to have the auditor explore further, is
20 management's estimate truly reasonable or is there
21 another number that is a better estimate? And it sounds
22 like maybe standards could more clearly direct the

1 auditor to focus on contrary evidence, as well as
2 evidence that merely identifies or supports what
3 management has presented. So that's just one thought of
4 what I heard in terms of accepting one piece when other
5 pieces might be out there.

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

15 But, seriously, I was wondering what are we
16 attacking here? Are we attacking a problem with the
17 existing standards, or are we attacking a design flaw
18 within the firm's methodologies, or are we attacking the
19 execution of those methodologies? And that's what I'm
20 struggling with right now is to what is really the root
21 cause here of these findings? Because these findings
22 have been here forever, and I'm very disappointed when

1 I hear professional skepticism because that's embedded
2 in what we do every day or we should be doing.

3 So, you know, is it the educational programs, is
4 it the design of the methodologies that we need to -- or
5 is it we need to re-focus the execution of those
6 methodologies?

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

15 You know, there's been increased guidance.
16 There's been better templates to use. There's some good
17 hand-holding that is going on. And, yet, not everyone
18 gets it. And that fact I think makes us say don't we
19 need to do something more? Don't we need to make a more
20 fundamental change, rather than continuing to reinforce
21 guidance, continuing to have trainings. As remedial
22 actions, those have been effective in driving some

1 improvements, and those are the kinds of things, some of
2 the things that we have seen quite a bit of in, you know,
3 assessing a firm's remedial action in the 12-month period
4 following their inspection report.

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

8 MR. BAUMANN: Brian Croteau?

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

15 One, certainly there is a range of performance in
16 what we see today as a recipient of PCAOB inspection
17 reports also through our own activities relative to the
18 involvement we have in our own enforcement
19 investigations. It probably should go without saying,
20 but our current chair, as well as multiple prior chair
21 and multiple commissioners, have pointed this out as an
22 area where they'd like to see the PCAOB, over many years

1 now, make some progress in updating standards. I'm
2 really happy to see a starting today with the discussion
3 of the inspection results. I think that's an important
4 place to start. It's probably a good time to also
5 congratulate Helen and the PCAOB for the great work
6 they've done to do something new in the inspection
7 reports.

8 If you haven't seen it in some of the large firm
9 reports that have come out, there's a specific appendix
10 that references specific aspects of standards that
11 haven't been complied with for every single finding.
12 And, certainly, before I came today, I analyzed that
13 relative to which paragraphs of the standards aren't
14 being complied with. And as we think about the issues
15 that have been raised today, I can't help but already
16 here some of the comments and think that an important
17 place to start is understanding what are the root causes
18 of non-compliance with some of those paragraphs of the
19 standards. And that may sound like it's in the weeds,
20 but if we're really going to solve problems here, I think
21 that's a place to start because I don't think there's one
22 root cause. I think there are multiple root causes, and

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1 it varies depending on a particular engagement. And from
2 what we can see so far, I think that's the case. I can
3 probably rattle off a few but will let others talk about
4 that today.

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

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

1 very short term on this effort.

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

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

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

22 In order to be a member of IFIAR -- we have 50

1 members. They cover the globe. Not all 50 of our
2 members but members covering the globe contribute to our
3 survey.

4 Back in 2012, the Financial Stability Board,
5 which was taking a keen interest in some of the
6 complexities of bank audits, challenges presented in the
7 financial crisis in bank audits, asked IFIAR if they
8 would explain a bit more what the challenges are that we,
9 as audit regulators, are seeing from the audits. THE
10 FSB's interest continues in this and, in fact, I think,
11 going forward, we will, their most recent press release
12 indicates that we'll keep talking about accounting for
13 financial instruments and, especially as new standards
14 roll out on loan loss provisioning, with a lot more area
15 of judgment, a lot more fair value measurement. This
16 conversation isn't coming to an end any time soon.
17

18 So the response to the FSB inquiry in 2014 was to
19 do this survey of all of IFIAR members not just on
20 financial institutions but on all aspects of audit. And
21 I'll quickly summarize the result of our most recent
22 survey. Our second survey was published in April of this

1 past year. It was on 2013 inspection findings. You can
2 find it online at ifiar.org.

3 Thirty of our members, again globally,
4 contributed to our study. And what we found was the
5 most, the area -- we had 16 different areas that, based
6 on our collective experience, were most frequently cited
7 in inspection reports. Of those 16 categories, the one
8 that had the highest number of findings was, indeed, fair
9 value measurement. Two places down from that, you have
10 revenue recognition, which is another area, obviously,
11 with a lot of judgment involved. So our survey actually
12 covered 989 public company audits conducted on audits of
13 113 firms so quite expansive.

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

22 There are limitations to the survey. The survey

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

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

18 So, again, if I were to reiterate, while the
19 survey is not an end on to itself, it is actually a good
20 point of reference to tell us what we need to be focusing
21 on. And from the results to date, it's clearly
22 indicating that fair value measurement is up there.

1 We are currently in the process of conducting our
2 2014 survey, and we hope to have that improved and
3 refined and informative next year. Helen?

4 MR. BAUMANN: Thanks very much, Liza. Bill
5 Platt?

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

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

1 at it.

2 So as we look at that and we think about if you
3 were going to then drive solutions that improve in those
4 three areas, rather than just a particular deficiency in
5 a particular estimate. And the other interesting part
6 is estimates are, there's a wide range of different types
7 of estimates. As you've noted, they're very complex.
8 There's probably not a one-size-fits-all solution. You
9 can't audit an allowance for loan loss the same way that
10 you would audit a fair value measurement, a Level 3 fair
11 value measurement. So there's some to this that's going
12 to be judgment and art as you design appropriate audit
13 procedures.

14 But I'd just be interested is am I missing
15 something, or is there more to kind of the causal factor
16 analysis? And then how would we best design standards
17 that would address causal factors instead of the
18 manifestation of the problem that they cause, which is
19 deficiencies in this area?

20 MS. MUNTER: When I was talking about the things
21 that we have seen in terms of what drives high-quality
22 audit work, that conversation is at a pretty high level:

1 project management, supervision in review, good
2 involvement of the partner, sort of some of the
3 intangible characteristics -- well, project management
4 is pretty tangible -- that apply to a particular
5 engagement team and drive the work that is done
6 throughout the accounts. And I think, as we are looking
7 at this problem, it's going to be focused at a much,
8 much, much more detailed level of what specifically was
9 able to drive a team to do good work with respect to a
10 significant estimate. And that is work that is in
11 process at many firms. That's work that is in process
12 for us.

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

18 So there's quite a bit more work to be done, but
19 I do think that looking at the causal factors and where
20 we have had deficiencies will progress. And I think
21 firms are driving that progression at that paragraph-
22 level of specific findings because that can be very

1 actionable in the short term, and that, of course, is
2 necessary from a remedial perspective, certainly given
3 our regulatory relationship.

4 MR. PLATT: Thank you, Helen. And I'm glad to
5 hear that, in order to really develop a standard in this
6 area, more work is needed and more insight. And I think
7 that I would encourage the staff and the firms to
8 continue to work on that to improve this project as it
9 goes forward.

10 MR. BAUMANN: And, Bill, we look forward to your
11 comment letter to lay out your thoughts. You've sort of
12 summarized some but lay out other thoughts in terms of
13 our potential standard in this area that we'd certainly
14 like to issue. Philip?

15 MR. JOHNSON: Thank you, Marty. It's a
16 reflection on what has been said, and other people have
17 touched on it. I'll make an overall comment to start off
18 with. I am supportive of bringing things, the standard
19 into one standard. I think it is important. There's no
20 doubt that a lot of the findings are failures to apply
21 or fully understand the requirements of the current
22 standards. But I think the world has gotten more complex

1 over the ten years that the existing standard has been
2 in place, and I think it's useful to refresh the
3 standards.

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

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

22 It might be my computer that has not picked up

1 the words, but I hope that, going forward, it is very
2 high in focus with regard to any potential new standard
3 because, ultimately, that is where the main focus should
4 always be.

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

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

22 MR. BAUMANN: Yes, I share Barbara's point that

1 I think a couple of you brought out that point. It's
2 maybe that estimates and fair value measures are so
3 challenging that, even though some of these concepts are
4 rooted in the fundamentals of auditing standards, they
5 need to be restated and emphasized in a fair value
6 estimates paper of the importance of challenging
7 management, the importance of skepticism in these
8 particular areas. So maybe it's really putting that
9 front and center in front of everybody in our standards
10 and firm our methodologies in these critical areas.

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

18 MR. RAMAMOORTI: Marty, I want to pick up on an
19 earlier comment you made which I think goes to the crux
20 of the issue. There is now an established body of work
21 in the psychology of judgment and decision making about
22 what's called a confirmation bias. So human beings have

1 a tendency to look for confirming evidence. So auditors
2 are no exception to that. I guess we all agree we are
3 human beings first before we are auditors. So we show
4 the tendency, and it actually can become very problematic
5 because you even engage in selective perception. You
6 look for what you want to see. And as a result, you have
7 this tendency to look for confirming evidence, rather
8 than disconfirming evidence. So that's just a natural
9 thing for human beings.

10 But with respect to auditors, I guess we need to
11 have some kind of intervention strategies to make them
12 question what they're doing, and that's part of this
13 whole, you know, professional skepticism conversation
14 that we are having.

15 I'll make one more comment, which is language is
16 extremely important in terms of standards. So a couple
17 of thoughts here. One, we tend to say that auditors
18 gather evidence to support their professional opinion on
19 financial statements. Well, we used the word "support."
20 We didn't use the word "challenge." So that's a
21 linguistic matter. And we'll say auditors should look
22 for misstatements in the financial statements. Well,

1 what about omissions? A misstatement by definition says
2 just that it's a statement. But an omission is not in
3 the statement.

4 So we need to worry about the use of language.
5 And whenever these kind of words are used, maybe there
6 should be a footnote that there is a converse to this
7 which will, hopefully, highlight for the auditor that
8 there is something else that maybe going on here that has
9 to get attention.

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

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

15 MR. BAUMANN: Thanks, Rick. Wayne Kolins?

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

22 MS. MUNTER: Yes, we have begun to do that. It

1 is on a -- we have begun that process. It's on a more
2 limited basis, but we have and firms have.

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

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

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

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

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

22 That makes the auditor's job much easier. The

1 auditor knows that. The auditor understands that. And
2 you can see that documented, I think, in the files. You
3 can see that documented in the client acceptance and
4 retention process that the firms go through, you know,
5 every year with respect to their clients.

6 So, yes, the issuer plays an important role. But
7 the strengths of the issuer, I would say, is not
8 determinative of the quality of the audit work that is
9 done. At times, you know, there could be a tendency to
10 say the issuer is so great at this, you know. The issuer
11 has all of these extremely high-qualified, high-quality
12 individuals who are doing the preparation of the
13 accounts, so I don't need to do much work because they're
14 much smarter, et cetera. So high quality in financial
15 reporting is fundamental.

16 MR. BAUMANN: And I think that's, we talked
17 earlier about the current standards not being linked to
18 the risk assessment standards, and a future standard,
19 Harrison, would be linked to them, could be linked to
20 them, and that's an important aspect of risk assessment:
21 the quality of the financial reporting, the valuation
22 group at a particular company and the controls there in

1 assessing those risks, the extent to which the company
2 itself challenges complex estimates and fair values. So
3 those are important aspects of linking risk assessment
4 into any auditing standard.

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

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

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

20 Our next panelist then would be Sandra Peters.
21 Sandy leads the financial reporting policy group at CFA
22 Institute and serves as a spokesperson for the CFA

1 Institute to various financial reporting standard-setters
2 and regulators. She's also a member of the IFRS
3 interpretations committee.

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

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

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

17 I, too, am happy to see that we started with
18 inspection reports. That's a great place to start for
19 setting the stage, and I think the panel did a great job.
20 Also interesting to note, I think relevant to what I'll
21 be saying, is that the highest number of findings was,
22 indeed, in fair value measurement.

1 And a number of people have asked what's the
2 problem that we're trying to solve? Is it with the
3 existing standards, or is it in design flaws with the way
4 in audit programs, with the way those standards are
5 applied? It's going to be my contention today that there
6 are longstanding auditing standards that are no longer
7 suitable in the current financial reporting environment.

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

16 But, fortunately, I don't need to say a lot about
17 how someone thinks about what investors should want
18 because the question that we're dealing with today is
19 very specific, and, in my opinion, there's little
20 controversy about the answer. The question is when a
21 judgment is required to arrive at a number in a financial
22 statement, how should investors want that judgment to be

1 made? And the answer is, I think, an investor should
2 want the judgment to be made in an unbiased manner.

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

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

22 Basically, AU 342.03 says that management is

1 responsible for the judgmental components of financial
2 statement numbers and what management chooses to consider
3 when forming those judgments is a matter of management
4 judgment itself. This longstanding foundational rule,
5 which, to the best of my knowledge, has no direct basis
6 in the securities laws, may have worked well enough in
7 the past, but perhaps this is what needs to be
8 reexamined. Does it promote the unbiased judgments that
9 investors should want, or does it hinder it?

10 Let me ask the question in a different way.
11 Imagine that accounting professor X, and I'm sitting next
12 to two other accounting professors over here. And I
13 apologize in advance for using the pronoun "she" in my
14 remarks.

15 Imagine that professor X permitted students to
16 grade their own exams. In determining one's grade, the
17 student may take into account its intention to learn the
18 material better during the coming months while studying
19 for the CPA exam. Professor X understands that she must
20 reign in unreasonably high grades, but that's not as easy
21 as it sounds. All of the students are giving themselves
22 the benefit of the doubt, so to speak.

1 Under these rules of engagement, professor X
2 certainly can't and does not wish to confront every
3 student and remove the bias from every grade. Despite
4 these obvious flaws, though, professor X must like her
5 system. We know that because she's the one who wrote the
6 rules into the course syllabus. Whatever the costs and
7 whomever bears them, professor X has fewer confrontations
8 with students over grades than any other professor, and
9 the students think that she's really cool.

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

16 My point is that AU Section 342.03, however it
17 came into existence, from an investor perspective, looks
18 like a standard created by auditors to benefit auditors.
19 And management, like professor X's students, is happy to
20 play along. But the system does a disservice to
21 investors because it deprives them of unbiased judgments
22 and even more so as accounting standards increase in

1 complexity.

2 To summarize, this section is a foundational rule
3 of engagement and it is not conducive to unbiased
4 judgments. Even the most highly-qualified and
5 intentioned auditors can be put between a rock and a hard
6 place. Consequently, the best that an auditor can do is
7 subjectively evaluate for itself whether management has
8 an appropriate or some would say reasonable basis for its
9 estimate. When the present doesn't look much like the
10 past, this can be a big problem.

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

16 Along these lines, I wanted to share this
17 anecdote with you. Please take a moment to read the
18 slide. Basically, as you're reading, let me just say
19 that that's Walter Schuetze telling a story from his
20 experience. He's one of the original members of the
21 FASB, a long-time KPMG partner, former SEC chief
22 accountant. And I think, as you read this story, it

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1 indicates that he's one of the most plain-spoken
2 individuals you'll ever meet.

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

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

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

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

20 On this slide, slide eight, I have barely
21 outlined the start of an iterative process to gradually
22 change how estimates are built into financial statements.

1 We've already talked about Level 2 or 3 estimates today,
2 and, initially, we could scope in only financial
3 instruments for which Level 2 or 3 fair values are
4 already being reported by large financial institutions.
5 These financial institutions would engage independent
6 appraisers to estimate the fair value of those financial
7 instruments.

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

18 If only this first iteration were to be
19 implemented, that would be substantial progress indeed.
20 But I also want to look ahead to the logical end point:
21 to purge financial statements of all judgment bias, most
22 likely by replacing management's judgments with market-

1 based drivers of value to be estimated by independent
2 experts. Let's see where that would lead us.

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

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

18 And, finally, the caveat. In my brief time, I've
19 provided you with only the barest outline of a new path
20 forward. We will not be able to resolve even a few of
21 the questions that we all have regarding implementation
22 and practicability, but that doesn't mean there aren't

1 solutions. I can't think of any good reasons why
2 practical solutions would not exist and why financial
3 reporting regulators would not want to look for them.
4 Thank you.

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

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

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

19 We care about auditing estimates and fair value
20 because, the CFA Institute, our members are major
21 consumers of estimates and fair value measurements. But
22 we also care about it because we have members who sit

1 within the big four firms who are consultants who work
2 as specialists to the audit engagement team. I've
3 recently participated in some conversations amongst the
4 firms and valuation organizations about how, in fact, we
5 can improve valuation specialists in the quality of work
6 and the identifying credentials associated with them to
7 improve the work that's actually done by valuation
8 specialists.

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

17 I used to fit within that category. As I said,
18 I was an audit partner. As my bio says, I was an audit
19 partner. I was also a controller of an insurance
20 company, and I audited insurance companies, so I was very
21 familiar with estimates and hung around with a lot of
22 actuaries who, as many of you may know, can estimate

1 anything. So I'm not certain to the point of someone
2 else made of what's changed because we've been making in
3 the insurance industry these estimates for a very long
4 time.

5 I can recall during the financial crisis, the CFO
6 at the time of the organization I worked for saying, "I
7 don't know why these people are so exercised about Level
8 3 assets. Have they looked on the liability side?
9 They're all Level 3." And so I'm not certain what's
10 changed, per se, because we've been doing this or we
11 perceive there have been estimates in the financial
12 statements for a long time. Certainly, some have
13 changed, and I'll talk about those in a minute. But
14 we're interested in it from a variety of perspectives.

15 Just here is a little bit about how we supported
16 over time. Things have changed a bit in what's in some
17 items have incorporated more estimates, and CFA
18 Institute, as many of you know, is a big supporter of
19 increasing uses of estimates and particularly fair value
20 for the last 20 years. We've supported 115, 133, 128,
21 changes in pension rules, et cetera, et cetera, because,
22 as someone pointed out, the past doesn't look like the

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1 future. And in making investment decisions, you care
2 more about the future than the past, so we care about
3 forward-looking estimates of value, not necessarily
4 amortized cost estimates or verifying amortized costs,
5 which is yesterday's perceptions of value.

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

18 But also challenging to investors, and what
19 struck me as I read this proposal was, obviously
20 challenging to auditors, is that there's such a variety
21 of different estimates. Some joke that we have our
22 favorite estimate, which is fair value. But when you

1 look at the financial statements, there's just so many
2 different types of estimates that have been made, and
3 there are compromises that have been negotiated over time
4 in revenue recognition, in the impairment of financial
5 instruments, as we see it playing out in the impairment
6 of financial instruments and impairment of intangibles
7 and long-life assets and, certainly, as we look at the
8 insurance liabilities project.

9 So the challenge for investors is what do these
10 estimates, what's actually behind them? They don't know
11 the accounting rules. They know cash, and they know fair
12 value, and what do these estimates actually mean? How
13 are they derived? What do they mean economically?

14 But as I look at some of the auditing standards
15 and some of the conversations, I sort of wonder if the
16 audit challenge, at times, isn't what are we auditing and
17 what do these numbers mean? And so how do we actually
18 employ audit procedures that are meaningful when we don't
19 know actually what this number can represent. So I
20 think, as I read this, I think that investors and
21 auditors might share some of those challenges.

22 Just in reading through the proposal, as I said

1 before, I found myself drawn to the details of the risk
2 assessment versus the substantive procedures, and I tried
3 to step away from the substantive procedures a little bit
4 because I'm not certain, as I said at the beginning, that
5 investors would necessarily know how those actually
6 produce what they want at times. Certainly, some they
7 would get, but how this proposal is changing things I
8 think is a bit challenging. A shift's chart that shows
9 how all this would be merged and what the significant
10 changes would be and how they would address the root
11 causes that investors hear about but they're not certain
12 why they exist at times would be actually useful.

13 I know I looked at the IFIAR survey, and I
14 certainly can see those categories. But I was left with
15 and why did they happen? And in the PCAOB findings, I
16 recall reading one finding, and it was about inventory
17 being the same last period versus this period and nobody
18 did anything to say, hey, maybe it's not impaired. But
19 I think the standard, actually, would have covered that.
20 I think some of it may have been in the execution of the
21 standard.

22 So investors are interested in the root causes

1 in, you know, which many people have talked about here
2 today already, which is do these things that you're
3 adding fix the things that we keep hearing about? And
4 I think for them to actually comment meaningfully on
5 that, I think that that's something that they need. They
6 need a bit of translation.

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

17 But also, as I step back from the proposal, I
18 thought that, from an investor perspective, the two most
19 important things to consider were a robust risk
20 assessment and an understanding of the current economic
21 context. And as I read the risk assessment standard and
22 I looked at the changes in AS 12 and AS 13, I thought

1 that they were useful. But I did wonder if it is really
2 about, as I said before, the execution as opposed to the
3 particular standard.

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

11 But I think also that sometimes I think auditors
12 are so busy doing the work that there's a necessary
13 aspect of sort of stepping back from things. I can
14 recall somewhere between QE 1 and 2 and infinity, sitting
15 with a bunch of insurance auditors and regulators and
16 them talking about why insurance companies were trading
17 at 60 percent of book value, and they didn't really
18 understand that, and I was shocked by that because the
19 knowledge of the low-interest rate environment should
20 have been incorporated into all of the estimates and
21 assumptions that were going into the financial statements
22 at that time.

1 And so sort of that step back. The market was
2 recognizing something maybe before the auditors and
3 regulators were. And that's something that, certainly,
4 when I look at AS 12, there's words, but I think
5 translating those words and having the education and
6 experience to translate that into practice is, you know,
7 one of our perceptions with respect to a root cause.

8 Also, as I've been in this role for five years,
9 one of the things I've recognized and come up against is
10 that many times people don't understand why we're
11 advocating for these valuations. Some people certainly
12 understand why we want them, and they don't like them,
13 and for good reason. Some people, though, don't really
14 understand why we want them. And it occurred to us that
15 maybe we should look at accounting education and how it's
16 evolved over the last 20 years or where it sits today
17 relative to the evolution of some of these standards that
18 have incorporated more valuation concepts over the last
19 20 years.

20 So we've undertaken a project over the summer to
21 look at that. And given that valuation is one of the six
22 audit assertions, and I can that it's only modestly

1 included, from what we can tell, in some of that
2 education, which is concerning to us with it being one
3 of the six audit assertions.

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

17 As I said, we think there's commonality,
18 sufficient commonality to merge. It's hard for us, as
19 investor and investor group, to assess whether this is
20 economically worthwhile because we need to know it's
21 solving the problems, as investors are the people who
22 will ultimately pay the bill. But, again, it's really,

1 for us, looking at the root causes. Is there sufficient
2 translation of education and knowledge and experience of
3 these auditing standards to what's actually getting
4 applied?

5 You know, as I read through some of the things,
6 as I said before, is this going to fix things, or is it
7 really about people having the ability to take those and
8 use them in the way and in the context that they need to
9 be used?

10 Investors as a group, as we've said, as I'm
11 certain my colleagues have said here before, want more
12 disclosures about these estimates and they want auditors
13 to tell them more about what they've done. And that's
14 really about the fact that they don't have a lot of
15 transparency over them.

16 So those are our thoughts on the importance of
17 the standard.

18 MR. BAUMANN: Sandy, thanks for those comments.
19 And I just want to ask you about one more thing. If I
20 got this right, early on, you said something else that's
21 not on this final slide, but you were pointing out the
22 number of CFAs who are actually auditors. And I think

1 you were pointing out it's a relatively low number.

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

18 MS. PETERS: Yes. And I think also that they may
19 not have the expertise to engage a specialist or evaluate
20 the work of a specialist either because you can't really
21 audit what you may not understand. And I don't mean that
22 in a -- I mean, I can look back at my younger audit self

1 and say I wish I understood that better. But I think
2 it's really hard to do the work if you don't understand
3 valuation concepts, you don't understand how cash flows
4 are derived, and you don't understand how discount rates,
5 or you don't understand in doing the good will impairment
6 tests the difference between a relative and a fundamental
7 valuation approach. I think it's challenging.

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

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

19 MR. BAUMANN: Thanks. Steve?

20 MR. BULLER: Thank you. I guess I'd just like
21 some clarification on, you know, this thought experiment
22 of an independent appraisal of all assets because,

1 obviously, companies want an efficient audit and quite
2 often companies have information which may be pertinent
3 in the evaluation process than you may be able to obtain
4 from outside sources.

5 So in performing an independent appraisal or
6 assessment, it seems to me that it still would require
7 the use of information that management may have in order
8 to ensure that you're considering all facts and
9 potentially information which may be more accurate and
10 relevant than you can get from third parties. I guess
11 on extent to which you would consider management data and
12 that process and also the extent to which in performing
13 an independent assessment, that you would still rely upon
14 understanding a company's internal controls and processes
15 as part of determining where the risk is in that process
16 and the extent to which you can rely upon management's
17 determinations in making that independent estimate.

18 MS. PETERS: Is that for me or Tom? Okay. I
19 mean, we do want to, we do think it's important to look
20 at management's estimates. We just think -- and the
21 internal controls and the processes. And, certainly, as
22 you said, there are types of estimates where only

1 management will have certain information about their
2 particular product or the like.

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

19 MR. SELLING: There's no question that
20 independent appraisers require the use of information
21 that management has. But I envision that the information
22 that management would provide to independent appraisers

1 would be fact based, would be factual, and that the
2 estimates, therefore, that appraisers would make would
3 be strictly market-based.

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

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

21 MR. BAUMANN: Kevin Reilly?

22 MR. REILLY: Yes, thanks, Marty. Tom and Sandy,

1 you threw out this notion of independent appraisals, and
2 I'll just give you the benefit of some of my experiences
3 over the years. The big challenge is pushing back on
4 appraisals I've seen that were not independent at all.

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

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

17 I believe that a starting point -- I mentioned in
18 my talk that I want the PCAOB and the SEC to look at this
19 because I don't see this as being just siloed with the
20 PCAOB. I think the SEC, as a starting point, would have
21 to do something similar to Article 2 of Regulation S-X
22 that describes what independent appraisers are.

1 Furthermore, I don't necessarily see that
2 independent appraisers are non-audit firms. Many of them
3 would be non-audit firms, but it could be that your firm
4 is the auditor and Bob's firm is the independent
5 appraiser. I don't have a problem with that. You guys
6 know how to be independent on engagements.

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

19 MR. SELLING: I guess I disagree. I think that
20 it is something we could look forward to in the future.
21 I forget his name. It escapes me right now. Former
22 Arthur Andersen partner, former FASB member, and

1 University of Illinois professor. Art Wyatt. Thank you
2 very much.

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

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

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

21 MR. JOHNSON: Thanks, Marty. It's really picking
22 up on Sandra's last point and the last point on this

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

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

21 MR. BAUMANN: Thanks. We feel that's an
22 important area, as well, in addition to the, as Arnold

1 indicated, they've come out with an auditor reporting
2 standard, and certainly the UK has had one in advance of
3 that, and it's an active project of ours. I think your
4 observation is a good one, as Sandy pointed out, too.

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

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

20 Frankly, the things that go in there are --
21 remember that it was started out with the hypothetical
22 market participant. So the hypothetical market

1 participant, in fact, doesn't have a bias if you've done
2 it right. And you take that information and you come up
3 with forecasts for the future, for 20 years in the
4 future, with growth rates for 20 years in the future.
5 Frankly, I don't know what our auditors could possibly
6 do to come up with that information by themselves,
7 knowing nothing about the product. And in particular,
8 when you're talking about things like in-process research
9 and development, you're talking about actually
10 assumptions around what's the probability of technical
11 success for a pharmaceutical drug? Not so easy. And,
12 again, I don't know how an independent auditor could come
13 up with such a valuation.

14 As far as having an independent valuation expert
15 for the auditor, I can tell you they use their own
16 specialists. I can tell you they go through and they ask
17 us lots and lots of questions about the assumptions,
18 which is exactly what I would expect them to do. In
19 fact, we do that before we give it to them.

20 Things come into us on the actual cash flows. We
21 go back to the people that created them and say, well,
22 this doesn't make sense or why would this happen? And

1 that's what you would expect management to do before they
2 hand it off to the auditors.

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

12 I did want to say one other thing on the
13 valuation and the point Sandra made about having people
14 study a little bit more valuation. I actually think
15 that's an excellent point. The field of study, the
16 things we do with valuation today are much more
17 important. They're pervasive in the financial
18 statements, and I think it's a great point on, you know,
19 really it goes to the licensing people, people who are
20 licensing CPAs. But given the amount of valuation that's
21 out there and the complexity of it, even management, when
22 you get to different levels of management, don't

1 understand what the differences between the valuation
2 they do for a financial statement or that occurs on a
3 financial statement and the valuation they do to assess
4 whether or not to buy a business. They are different.
5 The context is different, what drives them is different.

6 So I do think it's something that is important.

7 MR. BAUMANN: I think that gets back to that
8 point of the care that audit firms need to make in terms
9 of making sure that the people assigned to audits where
10 there are various types of differing complex estimates
11 and judgments have the necessary experience and expertise
12 with those types of complex estimates and judgments. So
13 thanks for those comments.

14 And I think I did say we have Bob to make some
15 comments, and then we turn back to panel.

16 MR. GUIDO: Thanks, Marty. Loretta, this was not
17 staged because I'll pick up from what you said. But I
18 think it all goes hand-in-hand.

19 A couple of observations. We have an
20 opportunity, and, as an audit committee chair, we have
21 an opportunity to continue to drive the COSO refresh
22 project through a lot of these issues that we're talking

1 about. And one of the things that I've asked my board,
2 the management of the boards I sit on is to really take
3 these judgment and estimate areas and really focus on
4 upping the game in the documentation of the process and
5 fully understanding of what management does to monitor
6 and measure these particular real tough areas.

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

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

21 Investors are trying to re-do these valuations
22 because they're trying to value the entirety of the

1 company, and they have little insight into them.
2 Certainly, as someone who audited insurance companies and
3 worked at one, I know that the only thing you know about
4 an estimate is that it's wrong and that what you want to
5 know later is why it was wrong and what changed.

6 And so that's exactly what reasonable investors
7 want to know. Was it because the market changed; oops,
8 we used the wrong interest rate; those sorts of things.
9 The problem is, and to Philip's point, there is no market
10 discipline around that because there is no transparency
11 around that. When you see impairment charges taken well
12 before they're taken in the financial statements, it's
13 because investors have valued the business based on their
14 estimates of the cash flows and taken them. And it's
15 almost ironic that we look to the market price to
16 determine the impairment because it presupposes that the
17 market has more information than management.

18 So we think that management's assumptions and the
19 like are very important. We'd just like to know more
20 about what they are and what auditors did around them.

21 MR. GUIDO: And, again, I'll just repeat audit
22 committee chairs and audit committees today, if they're

1 doing a great job, are doing exactly that. So just let
2 you know there is some oversight there going on.

3 MS. PETERS: No, I agree with that. I just think
4 that right now investors have a high degree of skepticism
5 about that, just what we hear from them.

6 MR. BAUMANN: Jeff?

7 MR. MAHONEY: Thank you and good morning. I
8 appreciate the opportunity to appear on this panel. As
9 a representative of institutional investors, I'm
10 obviously concerned about the PCAOB's observation that
11 there are "significant audit deficiencies" in the audits
12 of accounting estimates, including and in particular fair
13 value measurements.

14 My concern is heightened by several factors.
15 First, I believe fair value accounting with robust
16 disclosures provides investors with more useful
17 information than amounts that would be reported under
18 amortized costs or other alternative accounting
19 approaches. In 2008, during the height of the financial
20 crisis, the Council of Institutional Investors
21 commissioned a white paper for the purpose of educating
22 our members, policy makers, and the general public about

1 fair value accounting and its impact on investors. That
2 white paper issued in July of 2008 was authored by and
3 expressed the views of Stephen Ryan, who is the KPMG
4 faculty fellow, professor of accounting, and the director
5 of the accounting doctoral program at the Leonard N.
6 Stern School of Business at New York University.

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

14 It also requires or permits companies to report
15 amounts that are updated on a regular and ongoing basis.
16 And it can limit companies' ability to manipulate their
17 net income because gains and losses on assets are
18 reported in the period they occur, not when realized as
19 a result of a transaction. And, finally, gains and
20 losses resulting from changes in fair value estimates
21 indicate real economic events that companies and
22 investors often find worthy of additional disclosure and

1 other information.

2 In October 2008, following the release of that
3 white paper, the Council participated in the issuance of
4 a public joint statement with the CFA Institute and the
5 Center for Audit Quality about fair value accounting.
6 The joint statement opposed efforts that were underway
7 at the time by financial institutions and some of their
8 allies to force the Securities and Exchange Commission
9 to suspend fair value accounting for certain companies.

10 In our joint statement, we essentially adopted
11 the views contained in the Council's white paper and
12 concluded that "suspending fair value accounting during
13 these challenging times would deprive investors of
14 critical financial information when it is needed most."
15 In the six years since that statement was issued, our
16 position on fair value accounting has not wavered.

17 A second factor that heightens my concern about
18 the significant audit deficiencies that the PCAOB paper
19 has identified and which Sandra and Philip also mentioned
20 is that investors appear to assign a high value to the
21 auditors' testing and evaluation of accounting estimates.
22 I believe that view is demonstrated many ways but

1 including by the broad support that the PCAOB has
2 received from investors for pursuing improvements to the
3 auditor's report, improvements that would include the
4 auditor's assessment or insights on management's critical
5 accounting estimates and judgments.

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

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

21 My bottom line is, to the extent that the PCAOB
22 concludes that the significant audit deficiencies that

1 they've identified can be reduced, at least in part, by
2 improving existing auditing standards in this area, then
3 I'm very confident that many, if not most, institutional
4 investors will be strong supporters of that project.

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

20 With that final observation, that concludes my
21 prepared remarks. Thank you again for inviting me to
22 participate on this panel.

1 MR. BAUMANN: Thanks, as always, Jeff, for your
2 contributions as a SAG member and particularly today as
3 part of this panel. Guy Jubb's card and then Doug Maine.

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

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

21 The second is we look to auditors, I look to
22 auditors to ensure that the clarity of explanation and

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

12 Finally, I'd like to endorse Jeff's last comments
13 about the read across to the enhanced auditor reporting
14 project. This is something in the UK where we're now one
15 year into it and the issues around fair value accounting
16 and the estimates as being key risks. The additional
17 transparency that the auditors have provided has served
18 to not only enable a better quality of understanding and
19 engagement around those issues but has also led to an
20 enhancement of the appreciation of the work the auditor
21 has done and, thereby, the confidence in the financial
22 statements arising. Thank you.

1 MR. BAUMANN: Guy, thanks a lot for those
2 comments. I'd like to just address one. They were all
3 good comments. The first point you made about management
4 incentives and bias is a very important one, and I'd like
5 to just share that, as part of our project, the Board
6 adopted recently auditing standard number 18 on related
7 parties and, at the same time, we made amendments to
8 other standards regarding significant unusual
9 transactions and financial relationships with executive
10 officers. And so the risk assessment standards were
11 amended to specifically require auditors to understand
12 the financial relationships between the company and its
13 executive officers for the very point you mentioned: to
14 understand what incentives and biases could be there that
15 could be affecting management's judgments and estimates.

16 So that point is excellent and, again, another
17 important reason for us to make a very clear and distinct
18 linkage between some of those concepts in risk assessment
19 with auditing fair values and estimates. So I echo and
20 put an exclamation point on that.

21 Next was Doug Maine.

22 MR. MAINE: Thank you, Marty. I want to bring

1 the point of view of a former chief financial officer.
2 And I can tell you that there's nothing more contentious
3 than a challenge by my auditor to my fair value
4 methodologies and assumptions. And the reason for that:
5 because at the heart of it, you're challenging my
6 judgment.

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

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

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

22 And so I wonder whether or not there are certain

1 physical limitations that auditors are faced with with
2 respect to weighing in on the reliability of those
3 numbers. Now, I think disclosure could be improved.
4 Perhaps that would be the answer for the analyst
5 community. But that's a question for the accounting
6 standard setters or the SEC primarily, rather than the
7 auditors and the PCAOB.

8 And I get troubled when I hear the concept of
9 accuracy around a fair value measurement or an estimate
10 because, in fact, 24 hours after that number has been
11 marked, it's no longer relevant. It's not the number
12 anymore. So you're almost faced as an auditor with,
13 rather than trying to audit to the accuracy, in fact,
14 your auditing process is, in many respects, based on the
15 reasonableness and the integrity of management's process
16 in arriving at that estimate because there is no, per se,
17 right answer. There is a range. Unfortunately, balance
18 sheets have point estimates. Every number on it may be
19 even cash, I would often say every number, except cash,
20 is a range, not a point estimate.

21 So that's the physics of the dilemma that we
22 face. So I would hope with this standard-setting process

1 we can maybe address some of those physics and bake it
2 into the standard setting. Thank you.

3 MR. BAUMANN: Thanks, Phil. Jennifer Paquette?

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

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

22 From my perspective, it appears to provide better

1 alignment with the risk standards, as I said. I would
2 hope that it would improve audit quality and provide more
3 clarity for audit firms and enforcement staff by
4 producing a standard that is better understood by all.

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

18 Thank you.

19 MR. BAUMANN: Thanks, Jennifer, and thanks to the
20 panel for your contribution and for all the SAG members
21 for your valuable input to the panel discussion.

22 I'm going to turn to the last panel for this

1 morning, which is made up of two notable members of the
2 academic community who will discuss research conducted
3 in the area of accounting estimates and fair value
4 measurements and some related observations.

5 So we're pleased to have with us today Lisa
6 Gaynor, who is an associate professor at the University
7 of South Florida and holds the Robert Keith
8 professorship. Her major research examines the judgments
9 and decisions of audit committee members, auditors,
10 practitioners, and investors, and is focused on topics
11 related to auditor and audit committee communications,
12 independence, and the accounting for and auditing of fair
13 values.

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

20 Lisa?

21 MS. GAYNOR: Thank you very much. I first wanted
22 to start by telling you how we approach, how Jackie and

1 I approached this topic when we were first called
2 together and we worked together on it. We first looked
3 at the consultation paper, and we looked at what the
4 discussion questions were and we looked at what the
5 academic research, both being very familiar with it,
6 questions we thought we could address and then what
7 questions we couldn't address. And we put it into a
8 framework, and you can see the framework on the diagram
9 in the PowerPoint slides. And we tried to put the
10 literature in a way that we could understand what are the
11 problems that we note in the academic literature or the
12 academic literature has noted as problems related to the
13 auditing of fair values and complex estimates. And then
14 we thought we would look at why do we think we see those
15 problems where the auditing literature has determined why
16 those problems are occurring. And then we were hopeful
17 that maybe we could use the academic literature to give
18 us some fixes that we might also be able to address to
19 help with the standard-setting process. So that's the
20 approach that we're taking.

21 You can see that the topics that we're covering,
22 I'm thrilled to say and hear from this morning, that it

1 seems like at least we're on the right track. As
2 academics, we often get told that we don't know what's
3 going on in the real world, and we seem to have some idea
4 of what's going on in the real world because we're going
5 to talk about the environment, the characteristics of
6 estimates, the bias that is apparent in estimates,
7 auditors' knowledge or perhaps their lack of knowledge
8 on the auditing of estimates, how that affects their
9 processing, use of specialists, as well as their risk
10 assessments.

11 Okay. So first what I wanted to do is I wanted
12 to give the terminology that at least we use in the
13 academic literature where we talk about, when we talk
14 about the characteristics of estimates and fair values,
15 we use the term measurement uncertainty. And measurement
16 uncertainty basically means that there are well-meaning
17 experts that you can put into a room and they can
18 disagree on valuation or even the best method of
19 estimation, so it's a true estimation in that there are
20 many different answers to this question as to what is the
21 true number. There is no true number. It's an estimate,
22 and we don't know exactly what that number would be.

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1 There are a choice of models and assumptions with
2 no clear winner. And there are macroeconomic risks that
3 exist that, you know, observed crisis, may be
4 inappropriate, subsequent that would happen that we would
5 know that an estimate, an assumption that was made before
6 the fact no longer is pertinent in those estimate
7 processes.

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

13 So where we make a distinction with fair value
14 measurements and complex estimates is that we're looking
15 at a situation that we have inputs that are fed into a
16 model on the output or the outcome, where you have
17 complexity along the way, that inputs are surrounded by
18 uncertainty, you have unobservable facts that are based
19 on subjective assumptions. They go into a model where
20 it's not just one model. It can be a number of models,
21 whether it's Black-Scholes, lattice pricing models, or
22 what we'll see is also a series of models, not just the

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1 choice of one model, where management may use a weighting
2 of different models. So it's not just even one model.
3 It can be a number of models that management is using.
4 And then the outcome is a range of possible reasonable
5 estimates.

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

14 So the next slide you see is this is a study that
15 was put together by Cannon and Bedard, 2014. It's a
16 working paper right now. What they did, it's important
17 to see where these statistics come from and what this
18 means. This was 80 senior managers and managers
19 predominantly that were recruited by the CAQ for Cannon
20 and Bedard and were asked to come up with their 99 most
21 challenging experiences with a fair value measurement.
22 And with those, this chart compares, this is what the

1 auditors responded was the number of instances where
2 materiality, the comparison in materiality and the range
3 of estimation uncertainty. In this case, their range of
4 estimation uncertainty, just as defined as the reasonably
5 possible range of values for the fair value measurement.

6 What you see is that in 70 percent, looking at
7 that last column, the 26.5, 16.3, 9.2, and the 19.4, 70
8 percent of those observances, the auditor stated that
9 estimation uncertainty was greater than materiality. And
10 in 19.4 percent of the times, estimation uncertainty was
11 stated to be five times greater than materiality.

12 The highest number or the biggest area where you
13 saw estimation uncertainty being larger than materiality
14 was in the area of asset impairments. The most cited
15 area that auditors chose as the most challenging area was
16 in the areas of financial instruments.

17 So the next slide that we're looking at is now,
18 considering that we have this estimation uncertainty,
19 where auditors are trying to bring this inputs, models,
20 and outcomes into a range, comparing it to materiality,
21 we look towards what are the bias in estimates. There's
22 been many academic studies that some of you are probably

1 familiar with that have documented bias in accounting
2 estimates and fair values. Some are in terms of the
3 timing, and some are in terms of the valuation. You see
4 them in a number of accounts. Some of the studies report
5 that it appears to be opportunistic bias in terms of
6 earnings management, but most studies acknowledge at
7 least that it may be unintentional in some ways.

8 Two studies that, just in terms if you're
9 thinking about the inputs, the models, and the outcomes,
10 that we see bias along the way in terms of the inputs and
11 the models, we have Dechow, Myers, and Shakespeare, where
12 they report use of lower discount rates when
13 securitization losses, when there would be securitization
14 losses then securitization gains, in effect lowering the
15 losses that would be reported. Choice of models.
16 There's a paper that's forthcoming in one of our
17 journals. Bratten, Jennings, and Schwab show that
18 companies seem to choose the valuation model of Black-
19 Scholes or flexible lattice pricing model when it would
20 benefit them in terms of their compensation packages or
21 stock option pricing.

22 So we look now, if we're assuming that we have

1 these estimation uncertainty that gets put into the
2 inputs, into the models, we have bias that go into the
3 inputs and into the models, giving us imprecise outcomes.
4 We also wanted to look at what is the market's response
5 to these estimates. Academic research has shown that
6 estimates that are more likely to be biased are less
7 value relevant than other financial statement items,
8 suggesting that as estimates become less reliable they
9 become less useful to capital market participants and the
10 market places lower values on Level 3 estimates. But to,
11 Bob, your point is that result seems to be less when
12 there is better corporate governance. So audit
13 committees do seem to be able to mitigate some concerns
14 by the market for bias in the estimates.

15 The importance that we want to make clear here,
16 though, is that these studies are using stock price data
17 from markets, capital market stock price data in most
18 cases. And so these are audited numbers. So regardless
19 of whether this is intentional or unintentional, there
20 appears to be bias in these numbers and these numbers are
21 getting through the auditors to some extent. And so we
22 need to understand why these numbers are in the audited

1 financial statements, to the extent that there may be
2 bias in those numbers.

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

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

22 What I think is interesting is, when I'm looking

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

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

22 The areas that they said were most difficult,

1 were the most difficult to audit accounts were financial
2 instruments. Again, this relates to that table that I
3 had pointed to before, financial instruments that was 50
4 percent or approximately 50 percent of the times when
5 they were asked what was the most challenging experience,
6 50 percent of those auditors said it was financial
7 instruments, keeping in mind that the audit of financial
8 instruments may be more common than the audits of other
9 areas. But that was 50 percent responded that it was the
10 most difficult to audit accounts. And then asset
11 impairments was 30 percent, the next highest most
12 difficult to audit accounts. Asset impairments, again,
13 was the one that had the highest level of the estimation
14 uncertainty to materiality.

15 Also, in this study, 18.2 percent of the sample
16 or 18.2 percent of the 99 responses indicated that,
17 regardless of these large estimation uncertainty to
18 materiality differences or ranges, 18.2 of them proposed
19 an adjustment. So that comes to about 19 of the 99
20 responses or 19 of the 98 responses there was an
21 adjustment proposed. Now, this is a self-reported
22 number. This isn't going through the work papers and

1 actually looking as to what happened. But Jackie is
2 going to talk a little bit more about some of the
3 decisions that are related here, but in this study the
4 auditors reported that the reason that the proposed
5 adjustments -- I'm not going to say few but that the
6 ratio, the reason for the proposed adjustment was less
7 due about satisfaction with the estimate but more to do
8 about estimation uncertainty or lack of observable data
9 and the inability to verify.

10 Going back to the model where we have the inputs,
11 the models, and the outputs, there's another study by
12 Jeremy Griffin out of Notre Dame, currently at Notre
13 Dame, that's soon to be published. It's actually
14 available right now on the Web. He looks at the
15 subjectivity of estimates where he's comparing Level 2,
16 this was with audit seniors to partners, in an
17 experimental setting, comparing the subjectivity of
18 estimates, Level 3 versus Level 2.

19 He finds that, in certain settings, as
20 subjectivity increases, auditors are more likely to
21 recommend an adjustment and also a greater adjustment
22 amount. He also finds, though, that when outcome is more

1 imprecise determined by the range, the reasonable range
2 that the estimate may be, auditors are more likely to
3 require an adjustment when an outcome is imprecise and
4 the inputs are highly subjective when they're not as
5 subjective.

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

19 Interestingly, when managers, they also had
20 another condition in this experiment. When managers
21 include a footnote disclosure of the estimate, the
22 auditors require lower adjustments. I did want to say

1 to Philip I don't think this has anything to do with
2 critical audit matter paragraphs that some people might
3 jump on it. Basically, what this says is when managers
4 were required to put information about the range or the
5 estimation process, the assumptions that were used,
6 auditors were less likely to require an adjustment and
7 required smaller adjustment amounts. But that was what
8 managers were putting in the disclosures, not what
9 auditors were putting in the audit report.

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

22 And I think it was somebody -- I apologize for

1 not remembering. It was either Loretta or Sandra. Even
2 if this knowledge transferred, even if you were trained
3 in, say, one area of valuation, it doesn't necessarily
4 transfer, academic research, it doesn't necessarily
5 transfer into a different area of valuation.

6 And so the implication here is that the use of
7 specialists -- well, there are several implications. One
8 is including this in academics or in the university
9 setting may be a necessity, but also the use of
10 specialists is clearly a necessity. But I think what it
11 also comes down to is Jackie has a paper, Griffith et
12 al., that when they were interviewing auditors, as well,
13 and documenting the processes that auditors go through
14 and auditors themselves self report that the testing of
15 fair values is often conducted by staff inexperienced in
16 valuations and is supervised by those who often lack the
17 necessary knowledge to thoroughly understand management's
18 models and estimates. That could lead to the
19 implication, and I'm not going to put words into Jackie's
20 mouth, that this lack of knowledge and experience could
21 lead to, could contribute to the difficulty in validating
22 and testing management's critical assumptions and

1 estimates and reduces the auditor's ability to identify
2 and valuate or even communicate effectively concerns with
3 management. It kind of goes back to that lack of knowing
4 what you don't know and not being able to communicate it
5 effectively.

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

18 So the implication here is that this lack of
19 valuation expertise, lack of valuation knowledge could
20 be related to what, if you see PCAOB inspections, it may
21 have said lack of professional skepticisms or observances
22 where it really may be more about it's a lack of

1 understanding risk and a lack of understanding how the
2 risk feeds back into the process.

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

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

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

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

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1 ways to improve the audit of estimates.

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

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

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1 process anyway. And so they cut to the chase and audit
2 management's process.

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

17 Importantly, the auditors, the audit team will
18 retain responsibility for evaluating the overall
19 responsibility of the overall reasonableness of the
20 estimate. I will note that for difficult to audit
21 estimates, auditors do take advantage of the flexibility
22 that is available in the standards and do report for

1 these difficult to audit estimates, that they will use
2 multiple methods. They do seem to still overwhelmingly
3 audit the process or model, but they will supplement by
4 preparing independent estimates or using subsequent
5 events and data.

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

16 The other finding they reported related to risk
17 assessments was that control risk assessments and control
18 testing often don't lead to reduced substantive testing,
19 even for accelerated filers. And the reason given for
20 this was that controls are not precise enough to address
21 the specific risks related to the subjective assumptions.
22 They did note that this varied by account type, so

1 controls were more likely to be relied upon for financial
2 instruments and pension plan assets than for asset
3 impairments, which may not be surprising given what Lisa
4 said earlier.

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

22 The reliance on choosing to audit management's

1 process can make auditors a bit myopic. So choosing to
2 verify the process means that auditors often adopt a
3 step-by-step process. That means they're verifying each
4 of the individual assumptions used in the model, rather
5 than critically evaluating the overall estimate. And in
6 doing this, they sometimes fail to consider whether the
7 assumptions fit together. So they may fail to notice
8 inconsistencies among the assumptions and other available
9 data. They may fail to notice that there's other data
10 available in work papers that contradicts some
11 information that's being used in the estimate. They may
12 overlook information that is not used in the estimate,
13 but it's not included in the model at all as an
14 assumption and perhaps should be or, again, contradictory
15 information.

16 This is an especially difficult problem to solve
17 because it's very difficult to specify in advance using
18 a checklist or a standard what information may be
19 relevant to an estimate. But this reliance on evaluating
20 management's process seems to exacerbate this problem.

21 There are other problems related to the use of
22 specialists, so the current standards related to the use

1 of internal valuation specialists treat these people as
2 any other member of the engagement team, so AS 10 governs
3 the inclusion of these people on the team. And when
4 interviewed about how they use these people, how they use
5 internal valuation specialists, auditors report that the
6 lack of specific items about how they should use them
7 means that they have adapted the practices from the
8 guidance on using external specialists, but that guidance
9 is pretty silent on what valuation specialists do, how
10 they interact with auditors, and how they're findings
11 should be incorporated into the audit.

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

22 The comments related to misstatement evaluation

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

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

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

1 still very large.

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

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

17 So now some good news. So we're just beginning
18 to examine how to improve the audit of estimates. A few
19 experiments have examined auditors' critical thinking
20 about estimates and whether the resulting planned actions
21 would be effective for improving audit outcomes. We
22 think this is where the focus should be, rather than

1 merely on whether skepticism, as a nebulous concept, was
2 increased about the estimate. And we see some promise
3 here.

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

9 We look at changing auditor's focus to big-
10 picture goals, why you do something, rather than, away
11 from how you do something. And what we found is that
12 changing that focus made auditors more likely to notice
13 available information, information that was in the
14 working papers, that contradicted assumptions that were
15 being used to form the estimate. And, importantly, it
16 did this without any increase in time or effort involved
17 to complete the task. And this resulted in improved
18 identification of the biased estimate. So the auditors
19 rated this estimate as more biased and increased the
20 urgency with which they wanted to follow up on this
21 biased estimate and made them want to follow up on the
22 right things.

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1 So we think this change in focus holds a lot of
2 promise. Of course, it's one study, and we know that,
3 you know, we need a portfolio of research before we can
4 really move forward. But it's a start.

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

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

22 The current standards implicitly encourage a

1 step-by-step verification of management's process. The
2 standards currently provide much more guidance about how
3 to audit management's process than they do about how to
4 prepare an independent estimate or get evidence about
5 subsequent events data. And this may impede the
6 identification of missing or inconsistent assumptions,
7 so perhaps some guidance about how to effectively obtain
8 evidence from those other methods is in order.

9 Finally, the current standards on using
10 specialists don't provide a lot of guidance about using
11 internal valuation specialists. And so some guidance is
12 needed on when and how to use them and how to incorporate
13 their findings. And then, finally, the auditor's
14 responsibilities for accounts with extreme estimation
15 uncertainty are untenable. Clear guidance about the
16 audit evidence and procedures to address the risks that
17 are unique to estimates and fair value seems necessary.
18 Consolidating the standards would reduce uncertainty
19 about which standards apply. Guidance on how to reduce
20 the reasonable range in the presence of extreme
21 estimation uncertainty and what to do when it remains
22 after all options are exhausted would be beneficial.

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1 When extreme estimation uncertainty remains, we have to
2 consider whether investors have enough information about
3 this uncertainty. And, finally, we need to consider
4 whether it's reasonable for auditors to provide positive
5 assurance about this point estimate.

6 So thanks for inviting us today.

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

11 As I mentioned earlier, we really are looking for
12 comment letters, and that's very, very important to us,
13 in addition to the input we receive today. But it would
14 be great if the comment letters really addressed some of
15 these points that were made here. How should the auditor
16 approach situations where measurement uncertainty exceeds
17 by two to five times materiality, and how should auditors
18 approach narrowing that gap in reporting? And that also
19 does tie into the auditor reporting model project and
20 what the auditor report could say about such situations
21 where their report is based upon estimates that have
22 measurement uncertainty greater than materiality and then

1 also points about the skill set that the standards might
2 require that auditors, again, need to have necessary
3 appropriate experience and skills pertinent to the fair
4 value measures and estimates that they're dealing with,
5 as well as some of the bias issues and confirming versus
6 disconfirming evidence requirements that maybe should be
7 in the standard.

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

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

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

21 A number of SAG members have expressed concerns
22 about the problems of estimation range, so it's good to

1 see empirical data regarding the significance of that
2 problem. But I also would like to encourage us to think
3 about the relative significance of the problem of
4 estimation uncertainty versus concerns about biases,
5 again from an investor perspective.

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

14 Also, with respect to the criteria of value
15 relevance, while it's important in understanding the
16 economic significance of bias, and Lisa presented some
17 data about how bias affects stock values, I think that,
18 considered by itself, that actually understates the
19 problem, even though this data was pretty dramatic. It
20 doesn't directly address the corporate governance issues
21 of wealth transfer engendered by earnings management.
22 The statistical techniques that are used to measure value

1 relevance probably are not sensitive enough to pick up
2 on that type of effect, but I think that's very important
3 for the PCAOB to consider.

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

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

20 MR. BAUMANN: Thanks, Tom. Wayne Kolins?

21 MR. KOLINS: Yes, I had one question. One of
22 those slides mentions improving critical thinking, which

1 is a real fundamental behavioral trait. Do you think
2 that this is the kind of behavior that should be taught
3 at the undergraduate level, as early as possible before
4 the individual either goes into the accounting profession
5 or goes into private industry and is actually coming up
6 with the estimate?

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

18 So there's a well-developed literature in the
19 fraud paradigm that is starting to move over to the
20 estimates literature that shows that auditors are pretty
21 good at knowing where there's risk. They're less good
22 at identifying what to do in response to that risk. And

1 most of these studies, I'll say, have been conducted on
2 senior-level auditors. But these senior-level auditors
3 are the ones in the field doing the work and making the
4 first-line decisions and are the filter on what goes up
5 the line, and so their judgments are critically
6 important.

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

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1 approaching the picture, construals, mindset, putting
2 them into a different focus.

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

10 MR. BAUMANN: Thanks. Sri Ramamoorti?

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

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

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

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

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

19 MS. POLSON: I just wanted to say, as being a
20 practicing audit partner, a lot of the things that Lisa
21 and Jackie said are very true and is what you see
22 happening on this, you know, lack of knowledge of people

1 doing things. And I think a lot of it goes down to not
2 only the audit partner but then the audit team being able
3 to say I don't have the specialty and I shouldn't be
4 working on this. And part of that goes to the firm's QA
5 program. You know, they only assign partners that have
6 the proper industry area. Well, that should also be
7 going down the staff level to make sure that they can do
8 the work because that's how a lot of things are going to
9 get mitigated and they're going to be properly trained.
10 So I agree with what you're saying there.

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

20 And then that part where you're talking about,
21 Marty, of the whole piece of how would auditors then
22 address that difference would be good to basically get

1 us there because that's the whole part is how else do we
2 challenge and come up with the a company's estimates
3 without coming up with what our own answer would be.

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

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

17 (Whereupon, the above-referred to
18 matter went off the record at
19 12:41 p.m. and went back on the
20 record at 1:24 p.m.)

21 MR. BAUMANN: Great, welcome back. Nike, I think
22 there's a slide you have to put up one more time to

1 remind everybody that the views expressed by each of our
2 panelists who presented are their own personal views and
3 not necessarily those of the PCAOB Board or PCAOB staff.

4 So, the next panel is dealing with developments
5 and valuation. The topic of this panel focuses on how
6 valuation is evolving, both in fair value measurements
7 and other accounting estimates and what that could
8 potentially mean with respect to auditing accounting
9 estimates and fair value measures.

10 Our panelists provide a diverse range of
11 expertise in this area and we look forward to hearing
12 from them.

13 First, we have Sir David Tweedie, who is Chairman
14 of the International Valuations Standards Council. Prior
15 to this role, David was President of the Institute of
16 Chartered Accountants of Scotland and has served as
17 Chairman of the IASB as well as CEO of the International
18 Financial Reporting Standards Foundation, among many
19 other matters.

20 We also have Matt Brodin who's Director of
21 Interactive Data Corp's Pricing and Reference Data's
22 Evaluation Services Group. Interactive Data Corp

1 provides financial market data including evaluation
2 services, reference data and pricing services.

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

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

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

14 MR. TWEEDIE: Well thank you, Marty.

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

21 I first came across valuation when I was KPMG's
22 UK International Technical Partner in the '80s and one

1 of our clients had bought the company that manufactured
2 Smirnoff vodka. And, in those days, the rules were that
3 we didn't have intangibles on balance sheets, so it was
4 classified as goodwill and the UK had a rather bizarre
5 accounting standard that wrote goodwill off against
6 reserves. The result of which, this company was going to
7 have no net worth.

8 After some deliberation, we decided we'd allow
9 them to put Smirnoff on balance sheet as a brand but only
10 if we actually worked out how they calculated the price
11 they paid for it and that turned out to be a DCF
12 technique. And what we did is, we set out the rules that
13 we were going to look at this cash flow as it happened,
14 compare it against the price that they paid for it and
15 that was going to form the impairment model.

16 And that, in fact, did begin the impairment model
17 that we eventually adopted in the United Kingdom for
18 goodwill in brands. It spread then to the international
19 arena and, of course, you use it in the United States as
20 well.

21 When we first introduced it into the
22 international accounting, I remember the then chief

1 accountant to the SEC was almost apoplectic and said that
2 the United States had discovered the accounting for
3 brands and goodwill some 30 years earlier and that was
4 to write them off over 40 years.

5 And as I pointed out to the gentleman -- in the
6 United Kingdom, we have brands such as Gordon's Gin and
7 Johnny Walker, they're actually older than the United
8 States and, in my humble opinion, have done more for the
9 sum of human happiness than the United States and,
10 personally, I'd write off America before I'd ever write
11 off Johnny Walker Blue Label.

12 But these sort of things laid on to others
13 because the company then wanted to bring on its homegrown
14 brands and we wouldn't let them because we didn't trust
15 the valuation techniques. And that still has persisted
16 in accounting. There are very few homegrown intangibles
17 that are allowed on to balance sheets.

18 And when Australia adopted international
19 standards, Rupert Murdoch had to remove all his mast
20 heads from his Australian accounts, hundreds of millions
21 of Australian dollars, simply because we didn't trust the
22 basis of the valuation.

1 Business valuation intangibles is a growing area
2 in the valuation sphere, it's the younger area, the more
3 mature one is real estate but the real problem lies with
4 financial instruments.

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

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

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

18 I first came across them about three or four
19 weeks after Lehman's collapsed when I was attending a
20 Financial Stability Board meeting. And I can say that
21 I have never smelled such fear in a room as I did that
22 day. There was a general feeling that the whole

1 financial system would come crashing down.

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

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

17 But it became highly political. Chancellor
18 Merkel, Prime Minister Berlusconi, President Sarkozy and
19 President Barroso spent half an hour discussing financial
20 instrument accounting one day. Now I would have loved to
21 have been a fly on the wall listening to that, but that's
22 how serious it got. It got right to the top.

1 And in the heart of this, I remember being
2 interviewed by the BBC World Service and the interviewer
3 said, during this crisis, fingers are pointing and
4 fingers are pointing at you. You're the man who caused
5 the crisis.

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

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

18 But it became a highly contentious issue.
19 Companies, especially in Europe, were looking for ways
20 to escape using fair value. And they found a little
21 known line in the U.S. GAAP which said that in rare
22 circumstances, you could switch from fair value to cost.

1 Now rare in practice, in the United States, meant never.

2 But suddenly, we discovered that the European
3 Commission was going to change the law to make it
4 allowable despite what the standard said, to let people
5 go to cost. And our first reaction was, let them do it.

6 And then the SEC contacted us to say, you've got
7 to step in because if they do it, they're not going to
8 do it like the U.S. does, with the transfer of fair
9 value, nor is there going to be any disclosure, they're
10 just going to add back all their losses.

11 The markets won't believe the numbers. The
12 European markets will implode and that'll spread across
13 the Atlantic.

14 So within a week, we had to make a change in
15 accounting standards without any due process and we were
16 torn apart for it. The alternative was to watch the
17 markets blow up, so we felt we'd no option.

18 Bob had similar problems with Congress -- a
19 change that didn't put all the fair value changes through
20 profit and loss account, it went to other comprehensive
21 income. Europe instantly wanted that change as well, and
22 probably the only thing that saved us was the fact that

1 they wanted us to copy exactly what the Americans would
2 do in the future and when we mentioned that they were
3 heading for full fair value, that shut them up
4 completely.

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

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

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

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

20 But what both us, FASB and ourselves, did was we
21 required companies to show the fair value of these loan
22 books and then that is an area that causes problems. We

1 often talk about the figures in the accounts, but the
2 disclosure is important, too, because this was the check
3 on whether these loan books should be impaired.

4 And we had an example, just a couple of years
5 back, with the Co-operative Bank which showed that their
6 loan book was worth 37 million pounds more than the book
7 value -- which was the figure in the account.

8 After well known difficulties and their
9 regulatory scrutiny, they changed that six months later
10 to save -- well, actually, the fair value was 3.7 billion
11 less than the book value. And that started showing you
12 the unreliability of some of these numbers.

13 Hong Kong Shanghai actually stated in their
14 accounts in 2011 that comparisons of fair values between
15 the entities may not be meaningful and users are advised
16 to exercise caution when using the data. That was their
17 disclosure information.

18 There's been other worrying signs. Tests done by
19 banking regulators last year internationally using
20 hypothetical portfolios, which they gave to various
21 financial institutions, yielded large valuation
22 differences. We're not talking small ones, these were

1 huge.

2 And if somehow the more aggressive banks had used
3 the more conservative measures, it was estimated that
4 equity would probably have been wiped out.

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

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

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

21 Secondly, and the point that Jeff made earlier,
22 there is a problem about the valuation profession. Is

1 it a profession? And Jeff mentioned Paul Beswick's
2 comments.

3 So one of the things we're also doing is we're
4 setting out valuation professional standards, which deal
5 with entry requirements, exams, CPD, et cetera, as Jeff
6 mentioned. And perhaps even a common designation where
7 people will understand that these people aren't
8 qualified, like CPAs and things like that which have
9 universal recognition. But the qualifications at the
10 moment don't have that recognition at all. The idea is
11 let's identify the cowboys and those that are properly
12 trained.

13 There are various reasons for the differences in
14 financial instrument valuations. A lack of transparency
15 and poor disclosure about the purpose and basis, a lack
16 of precision around the language used to describe
17 valuations ---- it's often not clearly articulated when
18 it's commissioned, a lack of relevant market data or
19 market activity because the inherent features are the
20 product -- meaning there's no active market for it and
21 that is a particular problem within some of the banks
22 because the information is not in a public domain, it's

1 held proprietorially and it's very difficult to get
2 comparisons. And we're hearing that some audit firms are
3 even asked to sign confidentiality agreements not to
4 reveal this information.

5 Differences can be caused by inappropriate
6 models, errors in the way the model is calibrated -- such
7 as using price data for one range of products for another
8 range but without sufficient adjustments.

9 Relatively small differences in the inputs used
10 to construct a yield curve can lead to significant
11 differences in the value.

12 Different perceptions of the risk profile of
13 products. With more complex products, the greater number
14 of variables can lead to significantly different
15 perceptions of the risks.

16 And certainly when we look at things that are
17 traded -- are not capable of being traded to
18 third-parties, you end up having to construct hypotheses
19 and while the international and American standards set
20 the objective of a market exchange and stipulate that
21 unobservable inputs shall reflect the assumptions that
22 market participants would make, there remains scope for

1 different views on these assumed inputs with a resulting
2 effect in value.

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

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

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

20 But common standards will increase transparency
21 and help those relying on the numbers better understand
22 them, which in turn builds market confidence.

1 We can't make a hard to value asset easy to value
2 but we can show better disclosures and highlight any
3 material uncertainties.

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

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

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

20 What we intend to do in the new year is to hold
21 a roundtable where we get the industry together --
22 auditors, financial institutions, regulators, valuation

1 professionals, and can we agree to market consensus on
2 what is unacceptable and what is acceptable.

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

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

14 Thanks, Marty.

15 MR. BAUMANN: Thanks very much, Sir David.

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

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

21 And Jeff made the point earlier, about the
22 importance of raising the game of the valuation

1 profession because, in all too many cases, given the wide
2 range of professionalism and expertise, we do spend a lot
3 of time in the audit profession fighting with so-called
4 valuation experts that are not truly independent -- to
5 Kevin's point earlier. Yet, they have, you know, the
6 credibility of quote, unquote being valuation experts.

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

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

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

20 I also think that the point that a number of
21 people have raised -- you know, because that addresses
22 the execution in how the audits are performed today, but

1 it doesn't address the needs and wants of investors and
2 I think that there is a great opportunity through the
3 auditor's report and the expanded auditor's report to
4 deal with that element because I think these are areas
5 where we will definitely spend time speaking about them.

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

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

17 And the question comes up, well, that's different
18 than where you were last quarter and why would you make
19 that change given the fact -- if it's more positive, the
20 only external evidence that would be ---- we would call
21 triggering events, seem to go negative. Why would you,
22 therefore, change it to be more positive?

1 So, it's a very complicated topic and I think
2 there's a lot of moving parts in terms of disclosure, in
3 terms of outside service providers that are,
4 unfortunately, beyond the PCAOB's control but are very
5 important to how we do our work.

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

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

15 So, thank you.

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

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

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

22 In terms of Interactive Data, you know, creating

1 evaluations, we create just about 2.7 million evaluations
2 each day globally. That represents about 135 different
3 countries and about 50 different currencies. With an
4 average of about just over 200 evaluation staff that
5 evaluate these securities.

6 And the years of experience where we speak about
7 understanding the securities, the years of experience --
8 20 years plus in the industry and just about nine years,
9 10 years experience creating evaluations, so these are
10 professionals that know the marketplace, know the
11 securities.

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

17 So within a fixed income world, the outstanding
18 debt. There's only about one percent that trades --
19 estimated one percent trades, in any given day. So our
20 processes, our procedures, our systems and our evaluators
21 are all geared around digesting that market information,
22 those inputs, and then taking that market information and

1 extrapolating it out to price securities with similar
2 attributes. So, we look to maximize the use of relevant
3 observable market information.

4 So, let's speak about the inputs that go into the
5 evaluation process. You have trade information that gets
6 reported publically ---- both MSRB and TRACE for munis
7 and corporates. You also have some structured trades
8 that are starting to report in via FINRA, via TRACE.
9 There's still more to come on that.

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

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

22 Right now, you know, we've rolled out some new

1 systems. One of the biggest things we rolled out is
2 putting governance around the use of market inputs. We
3 created what we call inboxes, or market repository
4 databases, where we're getting market information from
5 the marketplace -- as I discussed earlier, the bids, the
6 votes, the trades and so forth.

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

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

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

22 So there's been a lot of money over the last

1 couple of years in changing the workflow of the
2 evaluation and in managing the data that we used in the
3 evaluation process.

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

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

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

19 A lot of times, the evaluators don't have to look
20 at each individual security because they just have to
21 look at an issue or curve, or a use of proceeds, or
22 sector curve for municipal bonds, or a specific category

1 within a structured arena in the MBS world.

2 So, there -- you know, therein lies a chance
3 where an evaluator can put this market information in,
4 create what we call an issuer curve and then price a
5 couple hundred bonds off of that curve and he doesn't
6 have to look at each individual bond.

7 There are instances where we do have to look at
8 each individual bond. High yield sectors is an example
9 of that, where each of those credits trade individually,
10 so we obtain market information for each one of those
11 bonds.

12 But where we can employ the efficiencies of
13 models and systems, we will do that to create the
14 evaluations in an efficient fashion. And that's what
15 we've been spending our time and money on over the last
16 couple of years, is putting governance around the
17 evaluation process ---- on the use of market information
18 in creating reports so that management can see what
19 market information the evaluator's obtaining, how he or
20 she is using that and whether he or she acknowledges that
21 information when they're creating their evaluation for
22 that day.

1 So, after -- you know, I'm not going to go
2 through methodologies and how we do all the evaluations.
3 I did that with the pricing task force a couple of years
4 back. But part of the process of creating the
5 evaluations is now from the audit side ---- and our
6 preparer's side, on transparency into the evaluation
7 process.

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

17 For the proprietary information, the quotes, the
18 results of the bid wanteds, the offers that we see in the
19 marketplace. That's information that's proprietary to us,
20 we can't display that information but we aggregate it
21 where we can, where we have a couple points for a
22 particular security, a couple price discovery points,

1 we'll create a graph so our clients -- the auditors can
2 see that that trade information or that quote information
3 compared to the evaluation we've prepared for that day.

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

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

13 Also, a part of ---- you know, over the last
14 couple of years, you know, speaking about changes, we --
15 you know, clients engage us in what we call due diligence
16 practices. They come in, they come into the floor, they
17 come into Interactive Data, they look, they speak to the
18 evaluators. And we go through, usually, an hour and a
19 half, two hours of discussions, methodologies, how we do
20 things, what we do, what our process and procedures are,
21 what our controls are, what our QC efforts are. We speak
22 about all that.

1 We also demonstrate to them and they sit with the
2 evaluators, they get to see the models, how the models
3 work, what controls they have in the models so they get
4 a feel for what the evaluators are doing each day.

5 We're spending more and more time educating
6 clients on that because they have to understand, in the
7 end, how we're creating our evaluations, what market data
8 we're doing, how we're absorbing that market data, what
9 kind of filters we use in the market data, because ----
10 as I said earlier, we created institutional round lot
11 evaluation.

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

16 Along with the due diligence meetings when
17 clients come into us, they also spend -- the Boards are
18 also spending more time with us. We're doing a lot more
19 Board presentations over the last couple of years.
20 Boards want to understand their third-party. How we're
21 creating the evaluations -- you know, at a higher level,
22 what controls we have in place, how does their pricing

1 committee interact with Interactive Data, what controls
2 do we see from them?

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

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

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

17 Also, part of the -- you know, with the auditors
18 interaction, while they do come to us on an annual basis
19 for due diligence, throughout the year we get questions
20 as their doing audits. They're questioning the
21 evaluations, they're questioning what market information
22 we have. Sometimes they have market information that we

1 don't have, sometimes we can share market information.

2 So, there's a lot of interaction between us,
3 between our clients, between our auditors in the end.

4 When I was asked to come here and present, it was
5 really about what's happened over the last couple of
6 years and, you know, that's some of the things that we've
7 experienced on the Interactive Data side.

8 But the marketplace is evolving, it's evolving
9 fast. It's probably evolved faster in the last three
10 years than it has in the last 20 years I've been at
11 Interactive Data.

12 Clients, the marketplace, everyone's using
13 technology better, faster and categorizing the
14 information and being able to demonstrate that they have
15 the information for the evaluation to support the
16 evaluation.

17 Also, transparency. As I said earlier, we created
18 a tool getting this market information out to our
19 clients. We have a web portal in which you can see the
20 information but we've also created downloads, in which
21 you can download this market information onto
22 spreadsheets.

1 Clients and auditors are looking for as much
2 information as possible when they're doing their -- when
3 they're doing their reviews.

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

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

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

21 But within a fixed income world, it's an over the
22 market counter place. As I said earlier, it's a hard and

1 it's a complex world. There's a lot of securities out
2 there, a lot of times these securities have individual
3 attributes and there's a lot of unique characteristics.

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

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

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

1 or illiquid.

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

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

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

19 You've got to go do your homework. You've got to
20 get as much information as you can find, have the
21 expertise within the evaluation staff to understand how
22 the marketplace works, have the systems in place and the

1 governance in place that you are getting this market
2 information, reviewing it and then, at the end of the
3 day, the quality control in looking at this information
4 and getting it out to our clients.

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

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

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

1 lot more of that.

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

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

10 Chairman Doty?

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

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

20 I'm thinking of the drug industry. In other
21 words, is there anything, or are we lacking in this, for
22 the protection of audit committees and users and auditors

1 -- are we lacking in this some check by others who are
2 not interested in the sale of the models and the use of
3 the models, and have you thought of building that into
4 your industry, into your commercial model in a way that
5 can nevertheless protect the proprietorial nature of the
6 data?

7 What I'm hearing is a very sophisticated and
8 highly designed system that is going to resemble a black
9 box to many audit committees or even auditors who are as
10 uninitiated and unsophisticated as I am.

11 So, how do you get assurance that the model has
12 been adequately tested, that it works and someone is
13 asking questions of it who might find a contradiction in
14 it?

15 MR. BRODIN: So, in terms of the model, yes --
16 getting the idea that it's not a black box because
17 ultimately, the end game, we see this market information,
18 we observe market information, we know the range, we've
19 spoken about this earlier, we know the range of the
20 evaluation in which we want to get to.

21 So, it's not a circumstance where the security
22 we're looking at, we don't know what it's worth and we

1 run a whole bunch of net present value paths out and run
2 the different -- a bunch of interest rate paths then we
3 look to see what the effect is on those securities.

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

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

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

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

22 We also will do some back testing to see where,

1 historically, how has our processes performed as the
2 trade information does come in. And it=s -- the numbers
3 are relatively good, they're relatively high in terms of
4 how the models perform.

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

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

21 So we do employ pretty sophisticated models but
22 ultimately, in the end, we know the range of the

1 evaluation in which we're going to.

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

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

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

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

19 And that is ---- so we'd see up in our staff
20 consultation paper the fact that we think that our
21 standard would have to address third-party pricing
22 sources, and we appreciate all of your participation in

1 that task force a while back and here today.

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

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

19 So this is a very, very important area to us.
20 Arnold indicated, as well, that the applicable ISA
21 doesn't have guidance right now with respect to pricing
22 services and this is just very important for us to get

1 in there. But we really need to hear from commenters
2 about their view on the transparency and ability to
3 recalculate values based upon that data.

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

11 MR. BAUMANN: Tom Selling?

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

17 The observation is that the accounting standards
18 have conceptualized current value as a non-distressed
19 exit price. And as David Tweedie explained, this can
20 create great problems for financial -- for valuation of
21 financial instruments when markets are inactive because
22 there are no willing buyers.

1 So my question for you, and again, I apologize if
2 this is naive -- the valuations that you're describing,
3 what do they represent? Do they represent -- do they
4 meet the accounting definition of fair value? Do you
5 ordinarily make a distinction between how much it would
6 cost to buy versus how much or the price you would
7 receive to sell? Or perhaps in the extreme -- in the
8 absence of willing buyers, do your models actually
9 perform?

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

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

21 Ultimately, in the end, if there was an instance
22 where there was no market information for us to build our

1 opinions of value, we would ---- you know, work with our
2 clients, alert our clients but we would stop the
3 evaluation process because we're always going to look to
4 see from market information as we are a market to market
5 evaluation service, we need the market information to
6 support our evaluations and we're always going to look
7 for that information.

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

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

21 So, we're not going to fair value to an intrinsic
22 value for what we think it's worth, we're always going

1 to need that market information to support our
2 evaluation.

3 MR. SELLING: Okay, thanks.

4 MR. BAUMANN: Thanks. Wayne Kolins?

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

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

16 I was wondering, and this is a follow-on to Jim
17 Doty's question, I think, that have you considered -- has
18 your company considered issuing a report on the processes
19 and controls, you know, a so-called service organization
20 report, that could be publically available in the
21 marketplace that I think could mitigate some of the
22 concerns about transparency, in terms of auditors

1 understanding assumptions and needing to understand the
2 assumptions and the inputs?

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

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

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

22 You know, there have been attempts and are

1 attempts to use algorithms and use models to do that
2 judgment piece with limited success.

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

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

16 But, ultimately, in the end, we've found, you
17 know, with the work we're doing and the government's
18 reporting around our evaluation process, as we're
19 beginning more efficient in digesting this market
20 information, the quality evaluations are getting better
21 because we have controls around the inbound information
22 and we have controls around -- the quality controls

1 around the outbound when we create the evaluations
2 looking at securities with similar attributes and making
3 sure we made the adjustment to the appropriate
4 securities.

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

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

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

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

21 And I had the pleasure of working with you on the
22 pricing services taskforce and I have some recollection

1 of some of our meetings there, enough to ask a basic
2 question.

3 It's just capacity, depending on where standard
4 setting goes on this and your capacity to potentially to
5 go deep dive, how many deep dives can you, you know, will
6 you go on tilt if every auditor under the sun comes to
7 you and, you know, CUSIP number by CUSIP number in level
8 two, given all the securities that Marty had mentioned
9 earlier, I mean, where does your capacity -- do you have
10 any concerns about where standard setting will go
11 relative to your capacity to respond to the marketplace?

12 MR. BRODIN: You know, that question was asked
13 during the pricing taskforce, if we had to do a deep dive
14 for everyone of our 2.7 million securities each day, I
15 think it would be overwhelming for us to satisfy that
16 need.

17 In terms of our transparency and the tools that
18 we've created, we do have the ability to download
19 assumption data, download reference data and be able to
20 download some trade information for that particular
21 security.

22 And, you know, there are algorithms in place to

1 draw -- where we can actually have the security in
2 question and have comparable securities where we see
3 market information.

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

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

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

20 MR. BRODIN: We plan on submitting.

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

22 Alan?

1 MR. MEDER: Thanks, Marty.

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

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

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

16 Financial analysts really love accounting
17 estimates. This is the closest thing they have to the
18 Full Employment Act. And you can't really see it on the
19 chart, but they're always looking behind the estimates,
20 they're trying to see what management may be hiding, what
21 gaps there may be between accounting impairment and
22 economic impairment, as an example.

1 But for this discussion, I'm not trying to train
2 you. These are training slides, we use them to train the
3 young analysts who, some of which, want to become
4 portfolio managers. They want to live with these risks
5 and the valuation problems each and every day.

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

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

20 So, I start with this chart and I start talking
21 about what's the difference between estimates and, say,
22 fair value? And I stress the bilateral nature of fair

1 value. I talk about how buyers demand matters and that's
2 why we show here a classic demand graph.

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

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

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

22 And to ease their fear, their burden, all I can

1 simply do is give them homework, give them education and
2 the chance for ongoing education.

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

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

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

19 Point estimates for us, and where we spend most
20 of our time, is wondering where on the continuum, where
21 in the probability distribution that's shown on that
22 chart might this security price move today, tomorrow and

1 the next day and why.

2 And again, to keep encouraging the candid
3 discussion and then I work -- I think about the work on
4 the valuation committee, and what is the, perhaps, the
5 point estimate that I'm always leery of that give us
6 concern on a daily basis? And I would simply say, I
7 would point to broker quotes.

8 I never get a broker quote that's a true
9 commitment. I get broker quotes that, late in the day,
10 I get whoever's on the desk that wants to give me a
11 number and I really don't have a lot of confidence in
12 them.

13 So, we spend a lot of time taking those inputs,
14 applying, perhaps, old tools, tools that we have from
15 third-parties such as performance attribution tools, and
16 we take inputs from the market that we've built into,
17 it's not big data, but data warehouses of some shape and
18 size, and we use that data and we discuss that data and
19 we try to come up with at least something that we can run
20 and be skeptical with against the broker quote that we're
21 receiving.

22 So, I would say that this is the third element

1 that I wanted to bring up as an internal development that
2 use. And it's the application of tools and data in a
3 consistent process. Maybe not a process that doesn't
4 change over time, depending on how market conditions are
5 changing, but a process nonetheless that we can really
6 discuss in a candid basis.

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

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

19 Another external development is, I would say, the
20 providers, the price providers like IDC might be getting
21 larger and more integrated but there are more price
22 providers available than I've seen ever before.

1 Providers like Market, Harvest Investments, even
2 Bloomberg's BVAL as an example.

3 And then you have EMMA on the muni side, TRACE,
4 there are a lot of tools that are available. And that
5 creates in and of itself two more developments. One is,
6 again mentioned by Matt, I think the providers in a large
7 extent are becoming much more transparent.

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

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

19 When you lose Lehman Brothers and Bear Stearns,
20 you have just less institutions selling and when you have
21 the proprietary trading desks and bank investment pools
22 and portfolios shrinking, again, you have fewer

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1 participants in the market.

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

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

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

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

21 Seeing no cards up at this point in time, thanks
22 to the panel. It was very, very informative on valuation

1 developments. I can see a great interest by all of us
2 in that area as it's so fundamental to this auditing
3 standard that we're dealing with.

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

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

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

19 And then also joining this panel is Larry Smith
20 who regularly attends our SAG meetings and who's a Board
21 Member at the FASB. Larry's had a long and distinguished
22 career in accounting. Prior to his appointment to the

1 FASB Board, he served as FASB's Technical Director
2 managing FASB's activities related to application and
3 implementation issues and served as Chairman of its
4 Emerging Issues Taskforce.

5 So, with that, Pat?

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

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

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

18 So, what I'm going to do is offer you a series of
19 five very concrete recommendations as it relates to the
20 consultation paper and then I'll relate some of those
21 recommendations to a new accounting standard that the
22 IASB published this summer, IFRS-9, which I'm sure many

1 of you are familiar with that deals with the financial
2 reporting for financial instruments. And in particular,
3 I'd like to touch on the impairment guidance that we
4 developed in IFRS-9 and related to your consultation.

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

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

16 Now, that recommendation ties into my second
17 observation and recommendation for you and I think it's
18 borne out by the presence of the three gentlemen to my
19 right here. And that is one of the most significant
20 trends in the area of making estimates about fair value
21 measurements over the last decade is the introduction and
22 use of third-parties to develop those estimates.

1 And as we've heard this morning, complexity
2 abounds in this area, particularly as it relates to the
3 collection of data, the use of assumptions and then
4 exercising judgment in applying that data and assumptions
5 consistently, if you will, to various models.

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

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

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

19 My third observation is a familiar one to all of
20 us here around the table and I will entitle it the
21 expectation gap and I think, Mike, you alluded to this
22 and I think even Marty, you may have mentioned it.

1 By adopting a single set of principles and
2 guidance in perhaps the most critical aspect of the
3 auditor's work, I think the PCAOB will be sending a very
4 strong signal to the marketplace that the accounting
5 profession, that can help the accounting profession in
6 two ways.

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

14 Interestingly, you know, I continue to hear in my
15 role as a standard setter, but in past roles as an
16 analyst and as an auditor, the refrain from very, very
17 experienced market professionals that the financial
18 statements are the responsibility of Deloitte or PWC, not
19 our responsibility. And I think these statements
20 essentially reflect the lack of understanding and perhaps
21 a gap in the understanding of what is, in fact, the role
22 of the auditor.

1 So, if you proceed with, you know, this process
2 of developing a consolidated standard, I would greatly
3 recommend that you coordinate it with an announcement by
4 the SEC, whether it's the Commission itself or the staff,
5 to emphasize the content and the importance of shared
6 responsibilities here to ensure that management
7 understands that it is their estimate and not the
8 auditor's estimate.

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

15 And I have a very specific recommendation here
16 that I believe is critical to an auditor getting a clear
17 and comprehensive understanding of how values are
18 assigned, particularly to complex financial instruments.

19 And this is based on my own experience as an
20 auditor, but also in recent discussions I've had with
21 people who are actually engaged in this process. And
22 that is that the auditor should have access to and be

1 able to observe the investment committee process of any
2 institution that is involved in assigning values to large
3 numbers of financial instruments. So that would be
4 insurance companies, banks, pension funds, endowment
5 funds and what have you.

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

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

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

21 My fifth recommendation deals with something that
22 we've heard a lot and, Alan, you've touched on this this

1 morning and it has to deal with education and the
2 experience of the auditor, and this is not a new issue
3 but one I think that is taking on heightened importance.

4 The recommendation is a reminder that there's a
5 close nexus between the knowledge and skills that you
6 have to have in the area of evaluating accounting
7 estimates and judgments and the need to have a deep
8 understanding both of an industry and the financial
9 reporting framework in which an auditor is evaluating.

10 And as I just said, we have to be honest, much of
11 the work conducted in this area of evaluating very
12 complex estimates is being conducted at a level on the
13 audit, perhaps sometimes, with the least amount of
14 professional experience and professional judgment.
15 Although, many times, that's overridden by reviews by
16 very senior people.

17 I believe in order to ensure that you have a high
18 quality audit, you need people with significant amounts
19 of experience. And if I'm correct and quoting Oscar
20 Wilde who said that experience is nothing more than the
21 name that we assign to the mistakes we make, unless
22 you've made a number of mistakes in this area, you're

1 never going to get it right.

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

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

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

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

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

1 requirement to develop a forecast.

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

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

17 They'll also need to understand how credit risk
18 changes in response to economic events as well as issuer
19 specific events. And they will need to assess the
20 quality of the systems used to monitor, to collect data
21 and effective those systems are in capturing timely
22 changes about credit quality.

1 So, as you can see, there's a wide range of
2 judgments and estimates that are incumbent upon
3 management and hence, the auditor, to evaluate the
4 impairment allowance.

5 And I think you can safely make the assertion
6 whether the measurement attribute is either fair value
7 or it's an entity specific measurement, significant
8 judgment comes into play.

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

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

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

21 And I'd certainly be interested in, again, the
22 comment letters that come in from various parties about

1 how this expected loss model works with the different
2 independent estimate or testing management's process and
3 does this present unique challenges when we're dealing
4 with something like this model of impairment on expected
5 losses, which is quite different than where we are today.

6 So, certainly want to hear about that as we're
7 developing our auditing standard.

8 Steve Buller?

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

11 I just wanted to comment on one recommendation
12 you made which was to observe the investment committee
13 process.

14 And, only because in any company, there are many
15 decisions that are made, including not just the valuation
16 of investments, but during a committee like that, for
17 example, that are also discussing possible new
18 investments.

19 But, if you think about it, companies also have
20 meetings on looking at loan loss reserves and tax
21 reserves and contingencies and I'm not sure that it's
22 appropriate to have the auditor involved in all those

1 discussions and if that's necessary to understand the
2 internal controls and to perform an assessment of proper
3 evaluation.

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

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

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

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

12 MR. BAUMANN: Jeff Mahoney?

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

16 MR. FINNEGAN: I don't think it changes the job,
17 to be quite honest with you, because I think if you're
18 going to expect the auditor to opine on the amounts that
19 are reported in the financial statements, you need to
20 have accounting principles that are going to faithfully
21 represent those amounts and drive towards that type of
22 conclusion.

1 So, I think IFRS-9 advances the quality of
2 financial reporting. Is it the model that I would have
3 developed and chosen? You know very well that I'm a fair
4 value proponent and would have a single measurement
5 attribute if I were king, but that's not where we are.

6 But the reality is, is I think IFRS-9 goes a long
7 way to improving, I think, the financial reporting that
8 will be made available principally by financial
9 institutions in the, you know, next several years.

10 MR. BAUMANN: Larry Smith?

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

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

21 I also agree with Mike Gallagher's comment that
22 I don't think there is a silver bullet out there because

1 I don't think that doing so really introduces a dramatic
2 change in auditing.

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

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

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

14 Depreciable lives of PP&E and intangibles. Under
15 the old rules before 141 goodwill life; valuation of
16 stock options; allocation of purchase price to acquired
17 assets and liabilities in a purchase biz-com; inventory
18 capitalization of costs and absorption both what you
19 absorb, what costs you absorb and how you absorb them;
20 inventory obsolescence; percentage of completion
21 accounting; impairment of PP&E intangibles and goodwill;
22 assessment of going concern; insurance companies

1 liabilities; pension obligations; realizability of the
2 deferred tax assets, other than temporary impairment of
3 investments; accounts receivable allowance; loan loss
4 provision for financial institutions; warranty reserves;
5 prepaid card fees and breakage; revenue channel stuffing;
6 revenue recognition from multi-element arrangements; loss
7 contingencies both the probability of loss as well as the
8 amount of a loss; evaluation of materiality; probability
9 of correlation of a hedging instrument to a hedged item;
10 residual values of leased equipments; salvaged values of
11 PP&E; is an investee a VIE and if yes, who's the primary
12 beneficiary and fair value estimates.

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

16 One is financial instrument impairment, we're not
17 finished like the IASB is; insurance target improvements
18 to accounting for a long duration contracts both in terms
19 of remeasurement of the liability and the discount rate;
20 leases, if we decide to move from our current FAS 13
21 distinguishing characteristics or criteria to an IAS 17
22 model, that will cause more judgments and estimates;

1 clarifying the definition of a business; determining
2 whether a host contract and a hybrid is more akin to debt
3 or equity; and hedging.

4 So, it caused me to step back and ask questions,
5 you know. Auditors have been auditing estimates forever
6 and what is it that's causing a need for a new auditing
7 standard today? Me defining that putting everything
8 together is not a fundamental change.

9 Or, is it fair value estimates only that's really
10 causing this demand? And if it is fair value estimates,
11 what is it about fair value estimates that causes us to
12 think that new auditing guidance is necessary?

13 Why are audit deficiencies so high? Are audit
14 deficiencies higher for all types of estimates or is it
15 just fair value?

16 And is it the accounting standards that are
17 influencing the rate of deficiencies and the perceived
18 need for a new auditing standard? Or, are there other
19 factors out there such as, increase in litigation or a
20 change in the regulatory environment, including the fear
21 of being second guessed?

22 And getting personal about it, from an accounting

1 standards setters perspective, if it's the latter concern
2 in terms of the environment in which people are reporting
3 and auditing, what implications does that have for
4 setting accounting standards?

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

9 Thanks very much. Comments? Questions? Kevin?

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

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

18 And I just have major concerns that we're trying
19 to take everything in that wide playing field and fit it
20 into a single box where we're dealing with economic type
21 fair valuation measurements along with non-economic
22 measurements such as warranty reserves. And I'm just

1 fearful that we create a standard that will end up
2 crashing under its own weight.

3 So, I would ask that the staff and the Board
4 consider perhaps an approach that would articulate some
5 broader principles in the audit of estimates and fair
6 value measures but then really think about some type of
7 an approach where supplements are developed to deal with
8 the use of pricing services or the expected audit
9 procedures undertaken relative to revenue recognition
10 which is an issue was talked about at the last meeting.

11 So, rather than try to create the aircraft
12 carrier, let's try to deal with this in more digestible
13 pieces to help drive longer term clarity in the standards
14 and hope for improved audit performance.

15 MR. BAUMANN: Good points, thanks, Kevin. And
16 Guy Jubb?

17 MR. JUBB: In responding to the question of what
18 implications does it have for assessing accounting
19 standards, perhaps we should -- the right question to ask
20 is, what implications does it have for setting corporate
21 reporting standards?

22 Because many of the aspects that we have been

1 discussing today are seeking to finesse a figure in our
2 financial statements which, as we all recognize, has many
3 variables associated with it and is not rather than a
4 science.

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

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

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

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

1 this table today?

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

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

18 Philip?

19 MR. JOHNSON: Thanks, Marty. It's really to
20 support what Kevin was saying because one of the concerns
21 I have because of the far -- we've heard from Larry how
22 broad the spectrum is. And we've got to be very careful

1 that we don't -- we're not too prescriptive in what the
2 auditor has to do because it is such a wide range and I
3 very much support what Kevin was saying that we shouldn't
4 move guidance into rules that have to be followed for
5 this very wide spectrum.

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

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

10 MR. CONN: Thanks. Just a couple of thoughts.
11 Can you hear me?

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

19 So, I think a challenge that the Board and staff
20 and all of us collectively as we weigh in, should
21 consider is how to bite off some of the issues and
22 pieces.

1 And I thought Larry raised some really good
2 questions. I thought he was going to answer them, but
3 he didn't. And I think that the Board and staff and we
4 collectively need to really pontificate on some of those
5 questions and try to come up with answers to them to help
6 inform the standard setting process.

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

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

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

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

22 What is the functional currency? What is

1 probable? What is more likely than not? What is a
2 constructive obligation? What is a cost that is eligible
3 for deferral? What is a self-constructed asset and what
4 is not? Is an arrangement a lease or something else?
5 Who is a customer and who is not? What is significant
6 influence?

7 So, anyway that's my list.

8 MR. BAUMANN: Thanks, and Pat and Larry, thank
9 you very much for your contribution to today's meeting,
10 to our thought process and for giving us a lot to chew
11 on in terms of our process going forward on the standard.

12 And thanks for SAG comments with respect to how
13 that could play into our potential standard.

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

16 (Whereupon, the above-entitled matter went off
17 the record at 2:58 p.m. and went back on the record at
18 3:19 p.m.)

19 MR. BAUMANN: Well, we have a very interesting
20 panel coming up now. We've talked about auditing all day
21 from a variety of perspectives, but now let's talk -- you
22 can hear from the Audit Committee and from the auditors.

1 Specifically in the panel today is going to be
2 Bob Herz, who's currently Executive-in-Residence at
3 Columbia Business School, Columbia University, and is
4 also a member of a number of very large boards.

5 Bob's extensive experience also includes serving
6 as past chairman of the FASB, past board member of the
7 IASB, and a past partner in a firm with me. We are
8 fortunate to have Bob as a member of the SAG.

9 We also have on our panel Tom Omberg. Tom is
10 Managing Partner of the professional practice at
11 Deloitte. He has served in a number of leadership roles
12 including leading the accounting, valuation, and
13 securitization advisory services. Tom, thanks for being
14 here.

15 And then we also have Jean Joy. Jean is the
16 Director of Professional Practice and Director of
17 Financial Institutions Practice at Wolf & Company. Jean
18 is also a SAG member and a member of the Professional
19 Practice Executive Committee of the Center for Audit
20 Quality.

21 So we greatly look forward to the perspectives
22 here now from the Audit Committee and the auditors on how

1 we should go about improving our standards in this area.

2 So, Bob?

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

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

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

19 If you think about -- in the development of the
20 fair value standard, we spent a lot of time on developing
21 the different levels in the hierarchy and within that on
22 level three, level three inputs in particular, there was

1 a lot of debate and gaining understanding of what was
2 currently being done at that time by valuation experts,
3 by pricing services, and auditors and very importantly
4 by the issuers.

5 And one of the things I recollect from that time
6 was that a number of parties said gee, you know, when you
7 get to these unobservable inputs and hypothetical
8 markets, we understand the objective, but it's going to
9 be tough and we don't want people having to do a search
10 and destroy mission to come up with things that are
11 inherently going to be subjective and the like.

12 And so you'll see reflected in the actual
13 standard, it's actual Paragraph 30 of the original
14 standard; I'm not sure where it is in 820 anymore, but
15 it kind of reflects a view that okay, we understand that
16 and those situations by necessity management's going to
17 have to come up with its best estimates of what it thinks
18 market participants, hypothetical market participants,
19 would be thinking.

20 But then it goes on to say however, if there's
21 actual market data readily available or reasonably
22 available with undue costs and effort, you shouldn't

1 ignore it and try and make adjustments.

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

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

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

22 Because the level three valuations previously had

1 largely been done on intangibles and some structured
2 long-dated type derivatives and the like for which there
3 wasn't -- that were tailored and that weren't traded
4 really.

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

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

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

22 And unlike for our corporate bond and equity

1 markets where we have put in periodic reporting to update
2 things, there wasn't good current information on those
3 things at all.

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

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

15 I also think the definitions counted a lot in
16 that, too. I think that there was a lot of stress in the
17 system and you think about behavioral impact, so at the
18 onset of the what was then called the credit crisis in
19 late 2007, I remember the CAQ tried to put out a helpful
20 white paper and it kind of dealt with this issue in
21 Paragraph 30 that said yes, well, you just can't go
22 automatically go to these management valuations.

1 There may be prices out there because the back
2 end of the paragraph says you can't ignore information
3 that's reasonably available and all that. Well, I
4 remember I got lots of calls from CFOs, even CEOs, saying
5 don't they understand how the market's not working now
6 and all that and what is available and what isn't
7 available and all of that.

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

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

19 And you change something in one part of it and/or
20 circumstances change, you get very interesting behavioral
21 reactions and pressures on different parties in the
22 system. Now, I think one of the hopefully good things

1 to come out of this from a systemic point of view is that
2 some of these things have been recognized, like the move
3 to provide better information, ongoing information about
4 asset-backed securities, to put more derivatives on
5 exchanges or through clearing mechanism may help with
6 some of this, but I don't think it's going to completely
7 take away those stresses and strains that occur either
8 in a crisis.

9 And just thinking about whenever there's a change
10 in circumstances within one leg of the reporting system,
11 whether it's change accounting standards or a new
12 auditing standard, that -- it kind of shifts kind of the
13 pressures and balances within the system.

14 Tom's going to talk about from the viewpoint of
15 some of the large firms some of the continuing challenges
16 and what they're doing around or have been doing around
17 that, and Jean's going to talk about from the small
18 auditing firms and their clients, the issuers, smaller
19 issuers, what some of the challenges are.

20 One point I'd make is that we talk about fair
21 value measures. Not all fair value measurements require
22 estimation. For level one, you know, quoted prices in

1 an active market, we accept the quoted price. It's a
2 fairly mechanical exercise.

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

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

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

22 It could be 200 years from now and there may be

1 different areas, methods, and the like, and in that
2 standard -- actually, in clarifying that standard in I
3 guess it was interpretation 47, we actually said you've
4 got a practicality exception if you can't really pinpoint
5 it with sufficient certainty.

6 You have to be able to kind of have a view of the
7 amounts and timing of how you're going to fulfill that
8 ARO.

9 Now let me take the other hat on here, the Audit
10 Committee perspective, and I'm on the audit committee of
11 two very major financial institutions -- Chair of the
12 audit committee of Morgan Stanley and I'm on the audit
13 committee of Fannie Mae, and we obviously -- fair value
14 and loan losses and all that kind of stuff are very, very
15 key to the whole financial statements and explaining our
16 financial position and our results.

17 And I would say both institutions prompted in
18 part by the regulators, we have put in what I regard as
19 pretty good governance processes and procedures and
20 detailed procedures of internal controls. We've got the
21 classic three lines of defense where somebody comes up
22 with the estimate.

1 There are separate groups to look at them
2 carefully, to look at the models, to look at the
3 assumptions, and then you have the internal auditors
4 coming behind to look at that and what I look for over
5 time is that less and less of the deficiencies are
6 spotted by either the second or third line of defense,
7 the separate valuation review group or by the internal
8 auditors. You want to see the quality being built in at
9 the front end.

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

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

20 I also like to get from the auditors each quarter
21 if there are changes what were the big subjective things
22 this quarter? Were there unusual changes or whatever?

1 I like to know all of that both from management and from
2 the auditors.

3 I like to know about -- somebody mentioned
4 consistency. That is very important, and part of that,
5 kind of that you didn't detect any overt management bias
6 in the going about the valuations or the loan loss
7 allowance or whatever complex and long-term estimate it
8 might be.

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

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

20 What did we decide going in? What are the real
21 challenges in it? We have, for example, at Fannie Mae
22 under a mandate to systematically reduce what's called

1 our retain portfolio of whole loans and asset mortgage-
2 backed securities.

3 And in order to decide what to sell when, we do
4 a fair value based upon what we could get in the market
5 at the time and we do what's called an intrinsic value,
6 which is a management estimation of the cash flows
7 discounted at a risk adjusted rate.

8 It's kind of a sell versus hold kind of decision,
9 but it's being regularly done in order to figure out at
10 what point should we make the sales and sometimes also
11 in what form.

12 Are we going to just sell them outright or are we
13 going to go into a securitization type thing where we
14 transfer -- retain some of the risk but transfer some of
15 it?

16 So, you've got to understand that, again, it's
17 not only the audit committee. This is tied into good
18 governance, both by management and by the board of
19 directors.

20 Now, from the PCAOB's point of view, a lot of
21 suggestions have been made. I'll give my own, but
22 there's always the issue of the -- I'll call it the

1 Hippocratic oath of standard setting.

2 It's not exactly do no harm, but it's make sure
3 that you're going to do more good, a lot more good than
4 harm when you create new standards in that, and that
5 takes a lot of judgment.

6 But, you know, I see, for example, the old
7 standards at least in the fair value portion were written
8 before 157, 157 or 820, sorry, 820, introduced new
9 concepts in trying to come up with a single definition
10 of fair value.

11 Certainly, level two and three, not all level
12 two, as I said, but that's an issue. We've talked about
13 the use of pricing services. I'll have some thoughts
14 about that. Valuation specialists, as well.

15 On auditing other accounting, as I said, they
16 vary. Somebody said there's a lot of variety between
17 them and they're all over the place and is it all of them
18 or is it which ones, do you need different guidance for
19 different types? What's common guidance? What has to
20 be detailed specified guidance?

21 The disclosures as the investors said are very,
22 very important. They -- we constantly heard that the

1 disclosures are as important as the actual point
2 measurements. And then, as I said, there are
3 practicality exceptions. How do you decide whether
4 that's a reasonable -- the company's taking a reasonable
5 out there or not? Is there proper disclosure of it and
6 the like.

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

20 Again, make sure you do consider the behavioral
21 impacts of what you write. It's very difficult to do,
22 but understand how people would react to specific wording

1 and the like. I asked is ISA 540 a good starting point?
2 It may be. I think we heard from Arnold this morning
3 that it may need some refreshing and they're very eager
4 to understand what's going on here and the like.

5 And then finally, I think as a lot of this
6 discussion today pointed out that this is not just a
7 matter for improved auditing standards. It requires
8 broader continuous improvement. It may be some thinking
9 to of the box, too, and I realize that may be beyond the
10 sole purview of the PCAOB, but it's certainly within the
11 purview of the various groups within the financial
12 reporting system.

13 This is not a new issue. This tension between
14 increased usefulness, relevance, and the pressure it then
15 puts on the auditor, auditing standards, and the like.
16 Lots of solutions -- not solutions, ideas have been
17 forwarded over the years.

18 I remember back in the '90s, Commissioner Steve
19 Walman had his notion of the colorized financial
20 statements with different levels of information, which
21 in part would depend on degrees of measurement
22 uncertainty.

1 I recall about ten years ago -- I guess it was 11
2 years ago in November 2003 there was rather an eminent
3 group convened by what was called the American Assembly
4 of Columbia University, and I wasn't associated with
5 Columbia at that point, but it was a group of -- there
6 were, I think, four -- the current chair of the SEC, Bill
7 Donaldson, was there. Bill McDonough and Charlie
8 Neimeier was there.

9 Ryan and Catherine Shipper were there, but there
10 were senior people from the accounting firms, from the
11 investor community, and the like, and it was really on
12 the future of the accounting profession, and it was a
13 wide-ranging discussion for three days.

14 But we talked a lot about this whole issue of
15 moving forward, the reporting to be more relevant but
16 then how do you deal with that in education? How do you
17 deal with it in auditing and auditing standards?

18 And actually a number of us in the room were
19 here. Not just me; I think Bob Guido was there. I think
20 Jim Cox was there, and I think there was even a very
21 eminent senior securities attorney from the firm of Baker
22 and Botts, one Mr. James R. Doty, there that was part of

1 putting this whole report together.

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

10 They happened to advocate the approach of more
11 the attestation around forecasting-type model. But that
12 -- it was just, again, trying to think out of the box.
13 I do think as some have said that we have made some
14 movement, both in the accounting and disclosure; probably
15 not enough.

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

21 And I do think, also, that the expanded order
22 reporting, which other people have mentioned may provide

1 a vehicle for improving the communication around this
2 area and maybe reducing what some people refer to as
3 expectations gap. Thanks.

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

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

21 And I know all of us on the audit side think
22 about guidance that we put out to our practitioners and

1 just looking at the guidance and the evolution of that
2 guidance around estimates and then I know there's been
3 a lot of focus here today around learning and just
4 looking at what we've been doing, not just about training
5 our internal specialists because we've been on a journey
6 and I think there have been some great comments that
7 certainly we'll take back around learning, but then what
8 we've been doing with our core audit professionals, as
9 well, just in the area of learning and trying to raise
10 the awareness and trying to increase the tools that we
11 provide to our professionals and also looking at
12 resources.

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

19 Helen had mentioned just sort of the inspection
20 themes and the inspection comments and clearly they would
21 reflect if there's challenges around auditing managing
22 estimates, and while we may have seen some improvement

1 recently, there's still areas for improvement. We've
2 still got a lot of things that we can look at and a lot
3 of things that we can do better at.

4 I think when we look at sort of where we are from
5 our perspective around this, there's a couple of themes
6 that come out. How we audit and how we use information
7 that comes from management specialists. That's an area
8 that I'll talk about because I think that's an area where
9 there are some things that we could probably improve
10 around how we use the information that comes from
11 management specialists.

12 And then how do we look at and how do we audit
13 and how do we document data and models, and I know
14 there's been some dialogue here around data and models
15 and the controls around the data that go into those
16 models. So, we'll spend some time talking about that.

17 It might be helpful just to spend a little bit of
18 time -- I know Matt provided some perspective around a
19 pricing service, so as we went back and sort of looked
20 at the evolution around how we think about fair value and
21 auditing fair value, clearly back right after the credit
22 crisis we stepped back and we looked at fair value and

1 we looked at how we were approaching the audits of fair
2 value and I think the consultation paper makes reference
3 of centralized valuation methods that some firms might
4 use.

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

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

18 We do a lot of due diligence on a handful of
19 vendors. We look at five vendors. We do onsite due
20 diligence annually where we send in teams of audit and
21 accounting professionals as well as our internal
22 specialists around fair value to really do a deep dive

1 and to understand how the pricing services go about
2 pricing, what information do they use, what quality
3 control do they have.

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

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

16 And just to sort of level set, I know Matt
17 mentioned that there's 2.7 million or so CUSIPs that they
18 price on a daily basis. When we look at the asset
19 classes that we think were reliable from an audit
20 perspective, and that's not to say that the other
21 information is not reliable; we've just held a pretty
22 high threshold around what we can rely on from the

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1 pricing services, they tend to be asset classes like U.S.
2 treasuries, asset classes like U.S. investment grade,
3 corporate bonds, and municipal bonds, U.S. agencies, so
4 Freddie, Fannie, Jennie notes that they issue off their
5 own balance sheet as well as some of the MBSs that are
6 guaranteed by those agencies but not all of them.

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

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

21 We're looking for transparency. We're looking
22 for homogenous. We're looking for things that while they

1 may use models to value them, the models are relatively
2 standard market models that anyone could reasonably back
3 test on their own or reasonably reproduce on their own.

4 And so we do that, as I said, for five vendors.
5 We provide to engagement teams fairly extensive due
6 diligence memos that include the interviews that we've
7 had and the onsite meetings that we've had with the
8 vendors, as well as the work that we've done.

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

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

1 the way down to the engagement level.

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

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

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

21 And so, I think there's other challenges that we
22 have around management estimates and fair value. I think

1 use of third parties I talked about and we'll go into
2 that in a little more detail, but the data in the models,
3 and I think it's been talked about a lot here today, is
4 just looking at illiquid, hard to value instruments,
5 understanding and documenting, how do you get comfortable
6 with an illiquid, hard to value?

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

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

19 And so when we don't have the model, and I do
20 think this is something, Marty, that would be good to
21 explore, is that when management is using a specialist,
22 I think the consultation paper makes reference to the

1 auditor looking at that as if management had performed
2 the work.

3 And I think the challenge that we frequently see
4 is it's very hard for us to do that because it requires
5 us to actually have the model and to be able to go back
6 through the model and understand how the inputs get to
7 the output.

8 And so I do think that's a challenge that we see
9 frequently as auditors is that we don't necessarily see
10 what happens inside the black box, and many specialists
11 are not always willing to share that for proprietary
12 reasons.

13 The models can be very, very complicated, and are
14 not things that you can generally just push across in an
15 email, and so that is an area that I think we do need to
16 explore is just how do auditors get comfortable with the
17 work of a specialist because it's not always possible for
18 the auditor to go through as if management had done it.

19 And I think it's also useful to continue to
20 highlight what's management's responsibility, especially
21 when they're using a specialist around getting
22 comfortable with the work of the specialist.

1 They can obviously evaluate the specialist, get
2 comfortable with the reputation, get comfortable with
3 their qualifications and their credentials, but there
4 still is the black box in the middle.

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

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

21 And so people have highlighted some very good
22 points around how do you develop those resources, how do

1 you train those resources, how do you take somebody who
2 is a deep mathematician with a trading background and
3 help train them in auditing and accounting in addition
4 to the deep expertise that they bring to the table.

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

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

19 So, they're very, very knowledgeable about the
20 markets, but as has been the point that's been made many
21 times is they're not necessarily connected to accounting
22 and to auditing, so that's a challenge that we continue

1 to deal with.

2 There's also a significant infrastructure that
3 needs to be put in place for specialists, in particular,
4 for fair value. If you look at the investments that we
5 make in data and the investments that we make in models
6 and that's a continuous.

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

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

22 And I think clearly we look at specialists and we

1 think of somebody who can provide information or can
2 provide an estimate about a unique asset or a unique
3 liability, and for example, somebody who's engaged to do
4 evaluation of a mortgage servicing right, which requires
5 deep understanding of mortgages, deep understanding of
6 the models that you would have to do to value that.

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

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

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

22 MR. BAUMANN: Before you do, I'll ask a question.

1 If there's some other cards that we'll see, as well.
2 But, Tom, you touched on a lot of really very important
3 topics that we set forth in the Consultation Paper, and
4 I'm glad you took them head on in your comments.

5 Certainly, we'd be very interested in comment
6 letters from you and from others that deal with the
7 question about the centralized approach, and as you said,
8 the macro due diligence that you did at five pricing
9 services, and then, how you communicate that to the
10 engagement teams, what the details and the levels of that
11 communication.

12 And then, I'm also glad to hear that that's
13 supplemented by additional testing at the engagement
14 level, and how you think that should be articulated in
15 your own guidance, maybe, but how it could be articulated
16 in an auditing standard, as well.

17 And then, at least, to the next major point that
18 I, you touched on a number of major points, but it's
19 clear that from earlier comments from the academics and
20 others that auditors tend to test management's process,
21 most of the time, to fall to that.

22 And you're right, we laid out in the Consultation

1 Paper that if management was relying on a specialist,
2 that if the auditor was testing management's process, one
3 possibility would be that the auditor would have to test
4 that data from the specialist, as if it was prepared by
5 management.

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

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

20 So to the extent they were using that as part of
21 their process, they needed to understand the key aspects
22 about that process, so they could take responsibility for

1 books and records, otherwise, I don't want to state
2 incorrectly, Brian, but I think, one of your staff was
3 pointing out they might have some issues, with respect
4 to internal control over financial reporting, if
5 management didn't understand that.

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

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

20 MR. BAUMANN: Jean.

21 MS. JOY: Thank you. And I'd also like to thank
22 the PCAOB for the opportunity to participate today,

1 because the conversations have certainly been
2 enlightening and clarify that this is not an easy issue
3 to deal with.

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

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

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

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1 and third party pricing services with smaller issuers and
2 their auditors.

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

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

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

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

22 In terms of other estimates, pension and post-

1 retirement obligations, stock-based compensation are very
2 prevalent in the smaller issuers, companies of all sizes.

3 And with regard to asset impairment issues,
4 because of our community banking clientele, we deal very
5 often with allowances for loan losses and the resultant
6 challenges that that estimate provides, as well as
7 goodwill impairment issues.

8 We thought about the support for, you know,
9 should there be a single standard that is addressing the
10 estimates and fair value measurements? And, you know,
11 I think the conclusions are mixed.

12 We would be in favor, on one hand, of combining
13 into a standard, as long as that standard could be
14 principles-based. And I think that's the challenge that
15 we were hearing today. And the comments that I heard
16 today, as well, were actually changing my focus a bit.
17 We do think that the standard needs to tie in closely to
18 the risk assessment standards. And if it is to be
19 principles-based, right now we have the standards that
20 continue to have lists, lists of prescribed procedures.
21 And is that really heading in the right direction?

22 We heard this morning about critical thinking and

1 whether or not something like that is really enhancing
2 the ability for critical thinking, and where that needs
3 to move might be more of a challenge. So I think being
4 very careful as to how these issues are compartmentalized
5 without a broad brush, but staying risk-based focused,
6 I think, is really helpful, and principles-based focused.

7 In terms of risk assessment, AS 12 provides
8 guidance for the auditor's assessment of the risk of
9 material misstatement, as we know. The concepts in AS
10 12 are well-defined. And the key to the auditor's audit
11 plan is really a well-founded risk assessment that's
12 grounded in the standard. And that requires that the
13 quantitative and qualitative considerations be
14 appropriately addressed.

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

21 In terms of the appropriate audit response, and
22 once we have done, hopefully, an appropriate risk

1 assessment, we deal with all three of the approaches
2 here. Testing management's process. It's often used for
3 estimates other than fair value. I think you'll find in
4 the smaller entities that fair value determinations are
5 typically not done with a management process, although
6 they may outsource that, or engage a specialist to do so.
7 But the estimates, typically, such as an allowance for
8 loan losses, would be based on management's process.

9 I think we also see, when we look at developing
10 an independent estimate, that there could be elements in
11 testing management's process that relate to somewhat of
12 an independent estimate, if you're actually looking at
13 independently assessing certain of the assumptions. And
14 you may independently estimate what you think certain
15 inputs should be, not necessarily the whole process. So
16 we also see some overlap there.

17 Developing an independent estimate is less
18 utilized for the smaller issuers and it's generally not
19 necessary for the non-complex estimates. That's where
20 I was indicating that if there was a complex estimate,
21 management would normally be engaging the specialists in
22 that regard.

1 In terms of reviewing subsequent events or
2 transactions, life would be so much simpler if we had
3 more ability to do that. But very few estimates are
4 actually resolved within the period subsequent to the
5 audit date and prior to the audit release.

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

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

21 And also in relation to management's bias that
22 relates to an estimate, because there may be regulatory

1 requirements that management has an expected bias for,
2 and an auditor has to at least understand what those
3 influences may be.

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

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

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

18 When we think about specialists, the auditing
19 standard for the work of a specialist we think is
20 fundamental to the audit process, and is really required,
21 particularly when you're looking at smaller entities and
22 possibly smaller firms.

1 Because what we heard today is the complexity is
2 so different today than maybe it was in years past, but
3 that specialist becomes even that much more significant.
4 To test any of the assumptions in data to the level that
5 we would be testing management's assessment, as Tom
6 indicated, would provide significant challenges, because
7 of the availability of the information and what we can
8 see and not see, and frankly, what level of expertise we
9 would have, or the client would have, to question some
10 of the detailed assumptions, which is the purpose for
11 engaging the specialists. So we do see challenges there.

12 I like what I heard today about raising the bar,
13 in terms of what other credentials that specialists
14 require and how we might make that more consistent and
15 assessable to the auditors and in their evaluation.

16 Third-party pricing. Many clients, most clients
17 use third-party pricing services. Sometimes there's a
18 limited number of those pricing services that are
19 available, particularly, if you look at the cost benefit.

20 So I think, based on what we've heard today, if
21 there is a way that we could test to the same source with
22 reliability, that would always be very helpful to the

1 smaller issuers and their auditors. But providing a
2 means to determining the reliability of that third-party
3 service provider, and relating that very specifically to
4 the risk assessment, these investments that are just not
5 difficult to price, combining that would be very helpful
6 in terms of executing the audit.

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

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

18 And we think that this will continue to be more
19 complex going forward. It will present challenges, so
20 the timing of this topic is very timely, and these issues
21 will continue to challenge the smaller issuers and their
22 auditors, particularly in relation to complex GAAP and

1 new estimates as we go forward.

2 We talked about the allowance for loan losses and
3 the expected credit loss model, revenue recognition. It
4 will not be any easier going forward, so we appreciate
5 the dialog today. Thank you.

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

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

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

20 MR. OMBERG: I mean, I would say a couple of
21 things. I mean, specialists, we don't see them every
22 day, but I would say, over the course of the year, you

1 know, we have a fairly significant number of clients who
2 we use specialists. And they could be, you know,
3 specialists to value a, you know, particular asset or a
4 liability, you know, that they have. But it's not
5 something that I would say is pervasive, but I think it's
6 something that. when we see it, becomes an area that
7 consumes potentially a fair amount of time.

8 So if we could change something, I mean, you
9 know, I think I would say this, you know, I said in my
10 comments, having the auditor look at it as if management,
11 you know, prepared it is a challenge. I mean, I think,
12 frankly, the best thing for us to do is actually to have
13 a more meaningful conversation, bring preparers to the
14 table, bring some specialists to the table, and have a
15 more meaningful dialogue around, how is it that an
16 auditor can get comfortable with a, you know, with a
17 specialist? And I think management probably needs to
18 have more responsibility and more ownership around a
19 specialist. I think maybe specialists need to be a
20 little more forthcoming.

21 I can appreciate the competitive issues and some
22 of the challenges they have around providing things that

1 they think are proprietary. But I don't think it's
2 something that we're going to solve just with auditors,
3 I do think we're going to need specialists and preparers
4 to the table to have a conversation.

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

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

19 What's probably most troubling these days is that
20 you can talk to different valuation specialists regarding
21 Level 3 investments, and you can have a wide variety.

22 So where that bar is, in terms of assessing the

1 qualifications of the specialists, many of these
2 specialists are very well-qualified, but they still have
3 different views as to what fair value is. And that
4 presents issues for auditors, as well as clients, in
5 terms of trying to reconcile what is the value that will
6 be reflected in the financial statements.

7 MR. BAUMANN: Bob.

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

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

18 And, you know, I kind of, you know, again,
19 thinking out of the box, I kind of like what Tom Omberg
20 said. Because part of the problem now is, as I see it,
21 you know, is when the valuation folks come in, and there
22 are varying levels of professionalism and work that they

1 do, but it's not always clear exactly how much they did
2 to obtain comfort with management's, you know, tying them
3 to the factual information, or maybe the projected
4 factual information, so to speak.

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

15 And sometimes, my perception, having been in a
16 client side, you know, it's a little bit of a war zone.
17 And that's very disquieting to, you know, when you're
18 sitting there and they're kind of, you know, there
19 doesn't seem to be any coordination, or the things are
20 not aligned properly. And I can see that happening.

21 And, you know, you think a regulatory point of
22 view, I mean, the UK hasn't quite gotten that far. But

1 if you remember, the FRC, as I remember, took over
2 oversight of the actuarial profession a few years ago,
3 as well, realizing how important those were to pensions,
4 insurance reserves, and the like.

5 So I think this kind of holistic system kind of
6 thinking about how do we really -- you know, the real
7 objective is to get more useful, more trustworthy
8 reporting in the hands of investors, you know, that's the
9 real objective.

10 MR. BAUMANN: Just one follow-up to Jeff's
11 question, if I may? Tom, I guess, in your firm, you
12 basically have specialists assigned -- you employ
13 specialists more than engage them, I think that was part
14 of his question, how you talked about management's
15 specialists. But with respect to your own, when you use
16 a specialist for your work, they're probably employed
17 rather than somebody you engage, is that fair?

18 MR. OMBERG: Yeah, I think they're all employees,
19 and we view them to be a part of the engagement, right.
20 So we do the, you know, training with them where we would
21 view them to be a part of the engagement team. If
22 they're being asked to do valuation work, or something

1 else, they're doing it as part of the engagement team.

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

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

10 MR. BAUMANN: Steve Harris.

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

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

19 And if it is a hugely significant range, where
20 should that be noted for the investor? Should it be in
21 the audit report, should it be otherwise? How do you
22 approach that?

1 We talked about Level 1, we talked about Level 2,
2 we talked about the valuation, the difficulty of it. But
3 when it gets to Level 3, I haven't heard anybody here say
4 that that can be valued, how it should be valued, or, if
5 it can't be valued, where should that be noted? Should
6 it be noted in a footnote, should it be noted in the
7 report, how do you go about solving that?

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

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

16 And, remember, 157 doesn't tell you where to use
17 fair value. That's another decision, project-by-project,
18 on specific topics that the accounting standard setters
19 then decide that. But they say, if they make the
20 decision that it should be used, then look to Section
21 820, now 157, there.

22 I mean, I think the thinking has been, and guided

1 by a lot of input from investors, is that directionally
2 correct information is more useful than precise but
3 irrelevant, non-useful information. And, you know, you
4 could debate that, but it causes a lot of discomfort in
5 the system.

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

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

22 The accounting standard setters have been

1 thinking about a presentation that shows what are called
2 "re-measurements" in a separate column and the like.

3 But then you get to the auditing. And what kind
4 of auditing assurance can and should the auditor provide?
5 Is it, you know, do we be much more explicit about what
6 that is and what can be provided, and it be explicitly
7 recognized that there are different forms and levels of
8 assurance for different forms, you know, of things in the
9 financial statements?

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

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

18 But that's different than the auditing. And if
19 the auditors are saying, at the end of the day I have to
20 rely on some specialist, management specialist who has
21 a black box that I really can't get into, then I think
22 the question being posed there is, should be audit report

1 say, we did an audit of the financial statements, except
2 with respect to X Y Z aspects, we relied on somebody
3 else, and the report reflect that we relied on another
4 party and we can't take responsibility for that?

5 MR. HERZ: Well, that's a possibility. In the
6 old days, in auditing, like in venture capital funds,
7 that's kind of what we did.

8 MR. BAUMANN: Did you want to make a comment,
9 Larry?

10 MR. SMITH: I was just going to add that -- and
11 this doesn't relate to the audit, but the accounting --
12 you know, 157, or 820, as Bob said, also requires not
13 only disclosure of the amount that's valued at Level 3,
14 but also what the significant inputs are, so that the
15 investor can see what the significant inputs are.

16 Now, the real question on the table that Marty
17 teed up previously was, well, should there also be some
18 disclosure of the degree of uncertainty that's embedded
19 in that Level 3 measurement? And that's a different
20 issue and it's an issue that people might raise to the
21 FASB.

22 MR. BAUMANN: Well, we have a lot of cards up,

1 and we have a 4:45 break time, and we still have to hear
2 from Barbara. So Barbara's summary may be very brief,
3 because we've probably summarized greatly. But I have
4 Professor Cox, Sridhar Ramamoorti, and Bruce Webb as the
5 first three.

6 MR. COX: So, Bob's two minute list and then,
7 Larry's ten minute list, just reminds us that one of the
8 exciting parts of accounting is it's just riddled with
9 account, you know, assumptions and judgments and
10 estimates.

11 It's always been the auditor's role to kind of be
12 the referee of that process against the rule book. And
13 my take on it is that fair value accounting has made just
14 a quantum change, I mean, a big change in scale, and
15 that's why we're talking about it now.

16 And I think that intuition was supported by what
17 we heard in the first panel today, that the category
18 where we're finding the most problems in the inspections
19 are areas of making these valuation judgments.

20 And I want to associate myself with what Kevin
21 said earlier and that is that, if you work on a standard
22 that's going to be really big, it's going to be an

1 aircraft carrier. And we all remember what happened to
2 the aircraft carrier release at the SEC sometime ago, it
3 never gets launched, and in fact, it started listing
4 before it even got near the water.

5 And at the same time, I don't think you don't
6 want to have a flotilla of the canoes, because they're
7 inherently unstable, to continue the metaphor.

8 So I think the way out of this process goes to
9 something that Bob just got through saying, and that we
10 have to make, at least when it comes to fair value
11 accounting, we have to make some judgment and some
12 decision about what is the role of the auditor in this
13 entire process. That's going to be our North Star here,
14 and with a North Star, I think it'll lead us.

15 And so I think we're always going to be
16 interested in problems of measurement. I mean, that's
17 what accounting statements are supposed to do, and that's
18 an inherent process. But I think we don't want to just
19 get tied up in looking at the measurements, because I
20 think that's going to lead us down the wrong path.

21 I believe that what you want to do, measurements
22 are important, but there has to be the forest that

1 everybody keeps an eye on, and that is what Tom was
2 saying earlier, that there were questions about whether
3 these measurements biases are bias. That is, are they
4 systematic? And that should make the alarm bells going
5 off.

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

20 And the role of this North Star that I'm
21 supporting here would be that there has to be not only
22 a governance standard, but it's got to be a well-accepted

1 method of valuation and the metrics have to support that.

2 And then just a final point I'll point out is
3 that when you read the cases that have been coming out
4 of the 2008 crisis, whether those cases survived a motion
5 for summary judgment, or didn't survive a motion for
6 summary judgment on the plaintiff's side, overall the
7 standards that were being used were not really good
8 governance standards.

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

15 MR. BAUMANN: Thanks, Jim. Brian.

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

20 But, you know, I think there's a difference in
21 the discussion of what was being discussed and what Bob
22 said what might be possible, relative to a scope

1 limitation. And then we might get into questions as to
2 whether that satisfies an issuer's filing obligations.

3 But I don't think, what I was hearing today
4 before, that was a suggestion that things can't be
5 valued. If there's a black box issue, we should be
6 talking about that and dealing with that.

7 But, today, I'm not so sure management, at least,
8 of public companies, can satisfy their filing obligations
9 with a scope exception of that nature. So I just wanted
10 to be sure that that wasn't left unsaid.

11 MR. BAUMANN: Sri and Bruce Webb and then Rick
12 Murray.

13 MR. RAMAMOORTI: You know, in a conversation
14 around financial reporting involving complex valuations
15 in foreign jurisdictions, I recall reading that, for a
16 small country, or relatively small country like, let's
17 say, Sri Lanka, there might be just one specialist in
18 that marketplace. That's it, just one.

19 And so while there may be no questions about the
20 competence of that specialist, I think certainly
21 questions about, you know, that specialist's independence
22 come up, particularly if they might be on, potentially,

1 both sides of a transaction.

2 And so I'm thinking, after hearing Jean's
3 comments, that for small issuers and small auditing
4 firms, this could also be a problem, in terms of the
5 large specialist firms perhaps being unaffordable, so
6 they have to go to, maybe, a smaller specialist firm.
7 And there aren't too many of them, and so you're stuck
8 with, pretty much, you know, just one firm. So, I don't
9 know, does that raise questions about, you know, what's
10 the quality of these, you know, estimates and pricing
11 information that you're getting?

12 MR. BAUMANN: Bruce.

13 MR. WEBB: I just wanted to respond a little bit
14 to Jeff Mahoney's observation and question. The
15 observation was that the PCAOB also had a project on the
16 use of specialist. And the question was, how often are
17 they used, internally and externally, and if one change
18 would be made in that area, what would it be?

19 And, I guess, I think specialists are used very
20 frequently, both by issuers and by auditors. And
21 whenever you're dealing with a fair value measurement,
22 whether that be a financial instrument, or a tangible,

1 intangible asset.

2 And I think the larger issuers tend to have
3 internal specialists, the smaller issuers tend to engage
4 external specialists, similarly with the firms.

5 And in the case of our firm, we're sort of a
6 middle market firm and I would say we're almost
7 exclusively internal specialists for supporting our audit
8 teams, although we do reach outside, occasionally. And,
9 Jean, on the other hand, whenever they need that kind of
10 help they would go outside. So I think you're going to
11 find it sort of runs the gamut, and it depends, to a
12 larger extent, on the size of the issuer and the size of
13 the audit firm.

14 In terms of the one change that maybe should be
15 considered is the Auditing Standards Board has separated
16 the requirements when using a specialist as an auditor
17 specialist from how you audit it when it's management
18 specialist. And I believe the ISB has done so, as well.

19 With that in mind, although the projects aren't
20 -- I don't know if you would combine the projects. My
21 sense is that use of a specialist is so intertwined with
22 accounting estimates that I would very much like to see

1 those two projects at least be on a parallel path.

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

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

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

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

19 It seems to me, Marty, that we started the day
20 with a centralizing set of themes. One was that the
21 valuation issues are homogenized, the values and
22 estimates are broadly in the same category of activity

1 and can be looked at in a spotlight.

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

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

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

17 And that some of the things that weren't fully on
18 the table at the outset, I think, have been valuable,
19 that the basic problem is valuation problem. That the
20 first recourse to deal with it is probably at the issuer
21 level. And I'm sharing here my view, rather than trying
22 to summarize.

1 And that the end of the day, there will be some
2 degree of unfair difficulty for the investment community
3 because it is the disorderly reality we live in today.

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

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

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

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

20 While we had a closing session scheduled to talk
21 about the paper more specifically, technically, since
22 you've all read the paper, you've already heard that

1 presentation.

2 It could be challenging to summarize any meeting,
3 but it's certainly more challenging to summarize what I
4 would characterize as just a great meeting full of
5 insightful, thoughtful views from all the participants.

6 During the meeting I summarized the comments more
7 broadly, but also more narrowly, just focusing on the
8 single standard approach discussed in the paper. And in
9 the interest of time, I'd like to go through those
10 quickly before we wrap up.

11 So, overall, I heard support from several
12 participants on support for one standard. We heard that
13 the standard might need to emphasize challenging
14 management, or maybe termed in another way, emphasizing
15 skepticism by the auditor, of bringing people to the
16 table that have the right skill set for auditing
17 accounting estimates or fair value measurements.

18 And also about the importance of a robust risk
19 assessment, which includes a thorough understanding of
20 both the estimate and fair value, but also of external
21 factors that could affect the valuation.

22 We heard that for a standard, it would be helpful

1 to have guidance for how to consider measurement
2 uncertainty and inherent and certain complex estimates,
3 even when that measurement uncertainty far might exceed
4 materiality.

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

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

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

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

1 principles-based enough.

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

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

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

18 MR. MAINE: I'll be quick. This is an
19 enlightened suggestion. Given that there's no regulatory
20 oversight for these very important specialists that we've
21 talked about all day, it seems to me an easy first step
22 would be for someone to issue some guidelines for

1 specialists in terms of certifications, experienced
2 background, and so forth, and let your humble audit
3 committees serve as the first line of defense to make
4 sure that the specialists that are engaged have the right
5 capability.

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

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

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

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

19 (Whereupon, the meeting in the above-entitled
20 matter was concluded at 4:43 p.m.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Standing Advisory Group

Before: PCAOB

Date: 10-02-14

Place: Washington, DC

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



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