Panel Discussion

Participants – In Alphabetical Order By Last Name (With Identifier)
Cindy Fornelli – Moderator (CF)
Jeanette Franzel (JF)
Scott Marcello (SM)
Roger Martin (RM)
Jeannine Strandjord (JS)
Joe Ucuzoglu (JU)

Opening Discussion

CF: Okay, ladies and gentleman, I know people are still gathering, but we are going to go ahead and get started, because I have a fantastic panel as evidenced by three of my panelists are giving addresses. You’ve already heard from Joe Ucuzoglu, you will hear from Scott Marcello immediately after this, and Scott is the Vice-Chair of Audit at KPMG, as well as the Americas Leader for Audit at KPMG International. So, you'll be able to hear from him, and have some time of Q&A with him as well. And, of course, to my far right, we have Jeanette Franzel. Jeanette is one of the PCAOB board members, and one of the only two that has a CPA designation, and I was telling Jeanette, not only is she one of the two CPAs on the PCAOB, she and Jay Hanson, in my mind are the only two practicing CPAs in the history of the PCAOB – so they have that expertise on the board. And you'll get to hear from Jeanette right after lunch.

And to round out our panel, to my far left, I have Roger Martin, who is at the University of Virginia, but perhaps more importantly for today, he is a KU alum – so welcome Roger. And then last, but certainly not least, to my right we have Jeannine Strandjord, who is the Audit Committee chair at MGP Ingredients, Euronet Worldwide, and sits on a number of other boards as well, including the Kauffman Foundation – which those of us from Kansas are very well acquainted with. And she, too, is a KU alum – so we're very pleased to have KU alums on our panel.

So, we've got a lot to cover today. We're going to cover three main topics. We're going to talk about the PCAOB’s as well as the CAQ’s audit quality indicators projects. We're going to talk about what audit committees want to know about audit quality. And, we're going to talk about some of the bigger topics that you heard Joe touch on – ICFR – internal control over financial reporting – in the audits, as well as the use of non-GAAP and other non-financial information in the marketplace. We will leave time for Q&A. We will do that at the end as Joe did with his discussion, and so I'm going to go ahead and get us started.

The subject, or the theme, of this year's symposium is increasing audit quality. And, of course, I think if we’re going to talk about that, to be true to the theme, we need to talk about what comprises audit quality. And so, the PCAOB has had a major project going on over the last couple of years, as has the CAQ, in trying to develop a set of metrics – or a set of indicators – that could help audit committees, and others, trying to ascertain audit quality – also known as audit quality indicators or the AQI project.
So, I'm going to start with you Jeanette, and if you could, give us a little bit of an update. First of all, maybe explain what the PCAOB did - you had your Concept Release that went out last year. I think the comment period closed in September of 2015 – so you got a number of comments. I know that at the PCAOB’s SAG meeting – the Standing Advisory Group - you also had a discussion in November about AQIs. So maybe some of the findings, some of the thoughts, and then we'll open it up to the panel to get to both the academic, the practitioner, as well as the Audit Committee perspective.

**JF:** Sure, thanks Cindy. Before I get started, I have to tell you that the views that I express today are mine alone, and do not reflect the views of the Board, or the Board members, or the PCAOB staff. As Cindy mentioned, we’ve had a pretty robust discussion about this topic in our November 2015 Standing Advisory Group meeting - we had a breakout session where people could have small group discussions to make recommendations and provide their thoughts. And we had reporting back out, which is publicly available. It’s out there on the web if you want to watch it. I did a presentation to Audit Committees in February, and I actually re-watched that session of the SAG meeting in preparation. I mean, this is getting really nerdy. Whenever I do that, I get so much more out of it the second time around. We really did a deep dive into some key questions at the meeting in November. We talked about AQIs and their content. Can a standard set of AQIs even be assembled? Which AQIs might be most effective? How would audit communities use them? Are they useful? And we discussed use of AQIs by investors. And, so those were the themes of our different breakout groups, as well.

There was general agreement that PCAOB should continue to perform work and study this effort – that this is a worthwhile effort. There was support for narrowing the list of twenty-eight [potential indicators]. When the staff proposed putting out that Concept Release, they said let's just go broad and get the feedback, and so, that’s a good principle to operate by, but twenty-eight is way too many. I think, we need to come up with a set of useful ones, and that doesn't mean that everybody has to use all of them. And that maybe audit committees and firms should figure out what works in their context.

We also got the message that we should not mandate the use of AQIs anytime soon, and I totally agree with that. In fact, if somebody asked PCAOB put out a proposal to mandate the use of AQIs – I don't even know what we would do right now. So, we’re going to keep studying this, obviously, and observing, and let experimentation happen. I think that is so important. We certainly applaud the efforts of the CAQ and various audit committees out there, and the firms, too – to the extent they are looking at this. So, we want to continue to let this develop and go down the path to see what happens next. Some investors did say that ultimately they want something mandated, but they were even saying it's too soon right now. So, that was, in a nutshell, what we got from the November SAG meeting.

**CF:** Excellent. So, Roger, I’m going to turn to you now. I know there is academic literature on audit quality in general, and, could you share a little bit? What’s some of the components or metrics of audit quality that researchers use to try to get that – get your hands around what are those components?

**RM:** Sure. And I'm pleased to see so many practitioners, because, I think my role here is how to simplify the academic research into terms that you can make sense of given what you do. There
are experts – my academic colleagues – that are experts here who do really detailed work in
everything that I’m going to talk about. So, what I'll do is I'll irritate them, and, hopefully,
present it okay. I also ask to remember that I’ll have to remember – so, Cindy hasn’t confessed
it, but she's a Kansas State graduate. So, one of my challenges is that I’ll have to use small
words so she can understand.

So, audit quality. I think that any paper dealt with audit quality in the past decade, or longer, the
authors claim they are researching audit quality. So, I'm not intentionally ignoring anyone’s
research. What I did – just to get a quick view for this panel – was that I did look back at the
last fourteen years of research – looking for terms like audit quality or auditor quality or things
like that – and found 220 publications in what I would call the top eight auditing related
journals. Almost two-thirds of those are what we call archival – which means we use
observable market data – it's available to the public – to find things that we might, or might not,
be able to learn about audit quality. Most of our research is based on what we can observe. So,
remember, we can’t observe the process very much – we observe outcomes – and that has its
advantages and it has its disadvantages.

The ways we have evolved to assessing audit quality focus on four things. One, two of these are
really black and white measures. So, one is going concern opinion – going concern uncertainty
– was or was not issued, and in hindsight we decide it should have been or should not have
been. So this is a two-by-two matrix if you think of either the auditor issued the going concern
opinion or they didn’t, and it turns out – in hindsight – that was good or not good. So, one
measure of audit quality is whether they got that right.

Another very coarse measure is a measure of after-the-fact misstatements. So, we discover after
an audit opinion’s been issued – in two or three or five or how many years – that it turned
out in the issuer having to restate their financial statements. So, that also implies that the audit
must have had something peculiar about it, and what we – all we can observe in research is –
well, it looks like the auditor got that wrong. But, we have to remember a couple of things. The
auditor was only providing reasonable assurance, so we don't expect them to be correct one
hundred percent of time. And, we can’t know what happened at the time. So, the condition of
the world that happened at the time of the audit that five years later looks very black and white
– remember, at the time of the audit, that's not true at all. So, they're making judgments and
there's some uncertainty around those judgments. We know that some of those are going to be
correct and some are going to be incorrect.

In academic research, we’re relatively comfortable lumping large numbers of these together and
looking at averages, because we're trying to make observations about this very big population
of auditors and opinions they’re giving. I'm not sure how helpful that is on the ground. Because,
if I’m an audit committee member or an auditor, I don't think those averages help me – because
I only care about one. I care about my audit, and so I think we have to remember that.
Academics, sometimes – and now I’ll really insult my colleagues – I think we take license, and
pretend like – well, if this is true on average, it must be true sixty percent of the time for this
client. Well, that's not helpful to that client.
Two other measures that I think are a little finer – or maybe a little more helpful. One is we look at accruals. So, we think we know and we think that we can predict the types of accruals that companies make, on average, based on their business model, based on their financial health, and things like that. So, we go in and we can compare basically cash flows to earnings numbers, and we try to estimate what we think the accruals must have been going on that time.

The second thing that we do along these lines is we compare actual earnings to expectations. So, expectations can be analysts’ forecasts, expectations could be prior-period earnings, but the idea is – we have an expectation of what earnings will be, and then we look at the distribution of, well, what were actual earnings? What did they turn out to be? And if earnings always just barely come in slightly better than last year, and that happens year after year after year – that begins to look a little bit suspicious, because nature probably has a little more volatility than that. So, we offer that maybe that means something’s going on there.

Now, again, this is very hard to help a specific audit engagement. Joe mentioned this earlier – and I think we need to remember this on the academic front – this might be a great risk assessment tool. So, it might be that we could come in – that an auditor could come into – a specific client. And, say that it seems like there’s a lot of unusual things going on with the accruals here – of course, the auditor is going to audit those accruals, but this might be an attention-directing tool that they could use in the spirit of risk assessment.

**CF:** So, Joe and Scott, I’m going to turn to you now. Based on those metrics or those data points that Roger just mentioned that are frequently used in the academic literature, do you find those as real drivers of audit quality or measures of audit quality? And if not, what do you use in the firms? Because I’m guessing you have your own.

**SM:** We do.

**CF:** Don’t fight each other for who goes first.

**SM:** We’re going to have to fight this out.

**JU:** So, historically, there has obviously been a focus amongst multiple constituencies – academics, the firms ourselves, clients, investors – on some measures of quality. But they tended to derive what I would characterize as output measures. So, after the fact, when the financial statements were determined to be wrong, the regulator came in and issued a criticism that the audit was deficient. And those things are clearly helpful and relevant, but they often come too late.

And I think part of the impetus for the project that the CAQ undertook, and the PCAOB studied – and that us as firms have been looking at for the last couple of years – is if there are more forward-looking indicators – and many people refer to those as input measures. And just to put this down at a plain English level, I’ll give you a couple of examples. So, in executing an audit, we found a high level of correlation between moving work up and avoiding a disproportionate number of hours coming at the very peak – after the issuer’s fiscal year-end. So, we can measure milestones and percentage of hours that are incurred in various phases the audit. It’s an
important metric. Leverage, similarly – what's the makeup of the team, what's the percentage of the hours coming from the partner, the senior manager, and all the way down to the first-year professional.

Now Greg Jonas – who was at the PCAOB and led this project – I think he said it best. None of these indicators actually give you the answer – they just give you very good questions to further pursue and explore. Is there an anomaly? Is there a potential cause for concern at a time when you can still do something about it? And so, we do use those types of metrics internally, and we look for anomalies across our issuer base. And, to the extent that there are issues that look like they're above a certain level of concern around the sleeve of measures that we use, were able to go in and be more invasive up front. And whether that’s getting the staffing corrected or whether it's getting the right specialists involved, we can do something about it before we wind up with an output measure after the fact.

SM: Yeah, and I guess I’d add – not repeating any of what Joe said – I got a couple of additional points. One, it’s a little uncomfortable sitting right here between Roger and Cindy – just for the record. But in all sincerity, the one thing that's interesting – and often quoted in fact – is when you have an audit bust, you can't necessarily conclude that the audit was flawed. And, a lot of times financial statements go through and are perfectly fine right in front of us, and you have no way of knowing whether the audit was good in that case – or not either. So, in some ways, it's kind of a very bad situation for an auditor to be in – because you can't demonstrate to the public, to the stakeholders, to your regulator the value of what you do very easily because there is no strong easy way to measure the lack of – a failure of – audit quality.

Having said that, I absolutely think that we’ve got a vision into having the metrics – we do have to make sure that we're thinking about full alignment. In my mind, that alignment is to really believe certain things drive quality, and we’ll keep refining those things as we move through time. We do have to measure – I mean – we have a hold ourselves accountable. And what accountability means is how to compensate people, how to recognize and reward people, how we evaluate the performance, you know.

And it has to be not just engagement specific – this does get to part of what the CAQ and the PCAOB have – it has to be the tone and the leadership sense of the organization. Are we actually driving the right behaviors? You know, to use Joe’s analogy – or if you're thinking utilization of staff matters in audit quality and over-utilizing staff, except in rare situations where it’s warranted, is bad for audit quality – are you holding the people accountable that schedule those staff to make sure they're in position to do the right things to make sure that they're at the right rates? And if not, you're going to have a problem down the road. And so, that's one piece of this.

The second is the notion of root cause analysis. We have to constantly ask ourselves – I think we fell in the trap, I know we did as a firm – I can’t speak for the rest of the profession – of just thinking we could solve all of our problems by improving our training – giving a few more processes and changing some methodology – and our people would do better. But, I equate that to – it’s kind of like the tourist who doesn't speak the local language deciding to yell a little louder hoping that the person will get it. Our people – it's not that the training doesn't work, it’s
that they need more than that, and so holding ourselves accountable to really understand what was causing issues in engagements – whether it’s findings from the PCAOB or others – and then really fixing the core – to me, is what’s really important. So, that's how I think of this whole notion of audit quality indicators being valuable in that context.

**JF:** If you don't mind, I'll just follow-up on what Scott said about how he’s not sure whether the other firms have gone through the same process – first fix the training, then fix the methodology, and then realize that it's really some of these input and process factors that are impacting quality. Many of the other firms also have gone through that process, and when you look at the standards in the history of the profession, it is interesting because the requirement for a monitoring function was really the after-the-fact internal inspections. That's how the profession thought about monitoring quality, and that was way behind the curve in terms of other professions and industries that have traditionally measured quality through the process. So, I’m thrilled that the firms are getting to these input and process measures.

**RM:** So, I'll jump in there, too, just to add one thing. So, when I said that two-thirds of the papers I looked at were archival, that leaves a very important one-third where we, in academic research, actually get into some of this decision-making judgment process. And, I certainly don't want to understate the importance of that research. Because, I think, that research can really inform how our auditors thinking, how are they making decisions, and also how to inform the firms about how to analyze that. Because it's very difficult to figure out how someone made a decision. Even with all the work papers in front of them, and all the information that they had at the time, you can't get into their head to think about what are all the factors that led to them making this choice. And I think academic research is making very good progress. I'm thinking about that audit process, and the firms and the PCAOB could benefit from really stopping to think about – alright, if we're learning from academics that these things are affecting the judgments and the decision-making, how can we use some of that? And that, I think, is very applicable – maybe more so than the archival, after-the-fact output measures.

**CF:** So, Jeannine, I want to get you in on this. Because you are the audit committee chair on the panel, and, ultimately, you are, in a sense, the ultimate judge of audit quality. And, certainly, these indicators of which we’re speaking are meant to help you in your role. So, what do you think of the indicators that Roger has mentioned – or some other ones that Scott and Joe and Jeanette have shared with us?

**JS:** Well, certainly I think those are important indicators; however, I care about the ones that are the input indicators – the ones that are going to keep us from having a bad audit. I am not concerned about the going concern – if we get to that point we’ve had – I no longer have a problem. I have a serious problem. So, I care about things like tone at the top; really understanding of the integrity of the CEO and the CFO, how geared they are to compensation; and then what that compensation plan does. I do care about – I look at the deficiencies every year – whether they’re significant or other deficiencies – and are those going down year after year, and are they getting better? Is a deficiency ever coming up in the second year? That matters to me.
Certainly the quality of the public accounting firm and the partner – and I don't care about the whole firm – I care about the group that’s on our audits. That's what's important to me. So, as much as I understand the PCAOB – you know, they always bring in, talking about the PCAOB, audit of the whole firm – certainly that's important. But, I really care about what happens with this particular audit, and what happens with this group. The audit partner. Is the audit partner - and when I talk about qualified, I'm really talking about really understanding the company. What makes it run? What are the risks from lines of this particular company? Industry experience would be very nice, because then they understand, you know, if it's a small transaction or large transactions, diversity of risk, etc. And it's very important to me that they understand the business. And so, we ask a lot of questions. I ask a lot of questions of them about what do they think of the finance staff, the internal audit group. Ask the internal audit group and the CFO of what do they think of the outside firm – and how good is the partner? I mean, that's very important. So, spending some time with the partner before the partner comes on the job – and really looking at the resume and what kind of experience they have. And, is it something that's going to help in this particular company? Any problems that come up during the year – and I'm not talking about the problems, the serious problems that are a significant restatement – I'm talking about the little problems that come up and what got missed. How did that get missed? And then, again, understanding the business – and that's something I'd also expect of the audit committee. They have to understand the business and what drives risk. So, those are mine.

Oh, by the way, to go back to Roger's point, we wouldn't count the number of accruals at quarter-end. We – in my audits – we actually forecast out ninety days. And to just give you a little rebuttal here – in the last forty-eight quarters, we’ve only missed earnings – that one-quarter earnings forecast – twice. And, we've always either exceeded or been on the forecast. Now, ninety days is not much. This is a company, by the way, that has get input from almost a hundred different groups – because we operate in 45 countries, there's three businesses, we get a hundred different people coming in with forecast – but they forecast out eighteen months. They do it every month, and they're very good at forecasting. But, we wouldn't be counting the number of accruals at quarter-end. It would be a monstrous job. And I think, to me, that's getting a little bit into the weeds. But, you know, you have to really understand the business, again, to understand whether it works or not.

**CF:** Well, Jeannine, you touched on some of the issues that will take us to our next session. Our next big area that we want to focus on – and that is what you really want to know about your audit. So, what we did at the CAQ is after we put out our quality indicator approach, and the PCAOB put out theirs, we had a number of roundtables over the summer last year. And then, we've had a couple of workshops where we brought together audit committee members to talk about, really, what do the audit committee members really want, and how do you go about assessing the quality in a real tangible way. And so, highlights from those discussions that we have had. And, in fact, we had the latest workshop just this week. What we heard from audit committee members, as I over-generalize and summarize, is that while they value the quantitative indicators that both the CAQ and the PCAOB put out, what they really would like help with – or what's really valuable to the audit committee – is those qualitative measures for those qualitative aspects of audit quality.
How do I get – you mentioned several times that what you really care about is your engagement
team – your lead engagement partner and your engagement team – how does an audit
committee member get a sense of the independence, objectivity, communication skills –
knowing how and when to ask the hard questions, knowing how we went to follow up with the
audit committee member? And so, I would like to spend a little bit of time, and I'm going to
turn back to you, and ask you – how do you get down a little deeper? So, all of these
quantitative things – the hours and the workload – important, but can you did a little deeper,
and what questions do you ask? What do you look for?

**JS:** Well, I think it's somewhat subjective, but I think it's getting to know your audit team,
getting to know the partner who's on your job. I do talk to the partner outside of the regular
audit committees, obviously, and even though you have your four audit committees a year, you
also have the earnings committee meeting before that. But, in addition to that, it's becoming
pretty common to meet with the audit partner before you actually have that meeting for
earnings release, and talk to them, understand what they're doing, understanding how they're
looking at the company. Again, understanding if that audit partner really understands the
mechanics of the business – what makes this business tick? Does he understand – does he or
she understand the real ethics of the leadership team? How is that…

**CF:** The company’s leadership team?

**JS:** …the company's leadership team. And they have to know them well enough to know what's
driving them. And, again, they should understand the compensation plans. Is there anything in
that compensation plan that's driving that CEO – or if that CEO then drives the CFO, that drives
the CFO to try to do something? I mean, I feel much better when I see a CFO stand pat on –
we're not going to get the same type of bonus this year. On one of my committees, they didn’t
make any covenants for two years in a row – and they stood pat and said – you know, we didn’t
make it, so this is how it's going to be. When they're willing to do that kind of thing, you have
much better feel that they're the kind of person that’s not going to try to fudge the books, and
make it look better so that they can get that next bonus. And that's, I think, very important. So,
those are some of the things that I look for.

**CF:** So, I'm going to turn back again now to Joe and Scott. You and your role as assurance
leaders in your firms meet with, and have had over the course of your careers, many
opportunities to meet with audit committees. Do these issues that Jeannine just raised – are
those what you’re hearing when you're in with the audit committee? What questions do they ask
you? How do you feel they're trying to assess the quality of both you as a lead engagement
partner and your team? Should I make Scott go first this time?

**SM:** I'll go first. I can think very, very much in line with some of Jeannine’s comments. I think
that it's part right – an audit committee is assessing individuals and their characteristics, and by
the way, most of the time they interact with those people, there's really no stress. There's really
no big issue – there’s nothing to judge, right? You really want to know what they're going to do
when things are difficult, when they have to make a tough call, etc.
So, one thing is when new partners are assigned, I'm seeing the audit committee is much more engaged in the selection of that new partner than they were five years ago or so. I think many years ago – five or more – they would have relied on the firm to assign the right person. Now they really want to go interview different candidates. They want to understand, well, who else I could work with. They’ll want to talk to the prior CFO, the CEO, the controller, people they’ve interacted with to get a sense of communication style, etc. They also want to interview them and really ask them questions about – how do you know about our business? What do you think about it? How do you intend to engage with me and communicate? And I will say it's a really important balance they're looking for, because what they want are people that can make difficult decisions, but they're also not looking for people that’ll cause issues or problems or chemistry problems when it's not necessary, right?

Because at the end of the day, the best, I think, teams work very well with their engagement team, management, and others to get to the right answers - to get the right information - but not so close that they can't be skeptical and objective and ask hard questions when it's the right time to do that. I think the other things they really do is they really want to drill down and understand. So, when you’re talking to management, what are you hearing? Who on my team isn't that strong? Because you can come back and say – look, you got the perfect finance team – you're probably not being totally candid with me, right? So, who is it really that our auditing team should worry about? What are some risks that are keeping you up at night? I know you’ve got the big presentation you have to present to the audit committee as the audit’s through, but if you had to pick the one, two, three things that are really, as the lead engagement partner, making you concerned each and every day, what is that? And how do you think about those things? And then, how can I as an audit committee chair do a better job in that regard around it? Those kind of interactions, I think, are the things that audit committees use to help assess their engagement teams.

**CF:** So, Joe, can I pick-up on that last point that Scott made? Because we are talking about audit quality indicators as it relates to the auditor engagement team, but, of course, there are many different factors that go into audit quality. It’s not just the audit team, right? There is the financial reporting team. There's the internal audit of the company. The CEO. The CFO. And, even the audit committee, right? The robustness of the audit committee. The skill sets of the audit committee have an impact on audit quality. So, how do you see that whole mix, and what do you do as the external auditor to try to get your arms around that as it relates to audit quality?

**JU:** Why, I echo Scott's comments - specifically as it relates to audit quality indicators. I actually have seen the proliferation of discussion around AQIs over the last year or two as a significant positive in trying to achieve these objectives. Because there's so much discussion in the broader regulatory community around the fact that audit committees need to set the tone that audit quality is paramount. And, that audit quality should be the primary basis on which an audit firm is selected and compensated and retained.

And yet, that's asking a lot of an audit committee if an audit committee doesn't have anything at its disposal that’s sort of tangible with which to evaluate that level of quality. And in the absence of that, at times, the conversation moves to price, because that's one very tangible
number. Am I getting a good deal on this? And if we really do want to come back – commoditization – and demonstrate that the audit – it is a value-added exercise where there is true differentiation – you know, a really good audit adds a lot of value for the corporation and shareholders – then we have to have metrics that allow for a dialogue that's more focused on quality than price. And AQIs give us the ability to do that.

Now, I know that Jeanette mentioned that there's no regulatory mandating on the horizon, and I whole-heartedly agree with that, but this is actually an area where the marketplace is working. So, contrast that to, earlier, we had a dialogue about why have investors not demanded more forms of assurance on certain measures and metrics, and I suspect that part of the reason is because the investment community is very diverse, and it's hard for them to get together with one voice and demand things. Well, audit committees – that's a bilateral engagement – the audit committee engaging with the auditor. And, as word gets out that there’s a tool that may, well, be effective at helping audit committees accomplish the very significant statutory responsibility they were given under SOX – to directly appoint, oversee, and compensate the independent auditor – audit committees are asking for this now.

So, I was with an audit committee yesterday before I flew out here, and we had a discussion about regulatory developments. And, this topic of AQIs came up. And the audit committee chair – this was not one of the engagements where we piloted it last year – but the audit committee chair said – you know what, that would be very, very valuable for me to receive on an annual basis in connection with me evaluating your performance. I'd like you to start reporting that. And as it gets more and more exposure in forums like this – as the PCAOB’s out talking about it to audit committees, as firms are out talking it to audit committees. You know, we go to the annual audit committee symposium, we had an entire panel on AQIs. The market pull from audit committees will naturally result in a proliferation, in my view, even in advance of any type of regulatory action.

CF: So, Jeanette, I know part of your role at the PCAOB is that you, particularly, are interested in liaison with and in dialogue with audit committee members, and that you have made that an area of focus for yourself over the last year or two. What are you hearing about audit committee’s use of either a subset of AQIs that the PCAOB has put out, and/or any of the qualitative components that audit committees look at?

JF: I think the feedback we’re hearing is very consistent with what's already been said. I do want to emphasize, though, were talking about big company audit committees here, for the most part. We ought to distinguish between what we're seeing with Fortune 500 companies versus mid-cap companies and small companies. We’re hearing from audit committees they want to know about their own audit – they want to make sure the audit firm has assigned the right partner and the right team; that the firm is providing enough resources to the team, but with the right amount of balance. They don't want the engagement partner to have to call the firm’s national office every other day. So, there's kind of a balancing act there.

I find it very interesting and positive that audit committees are even using the word professional skepticism. I don't think five years ago audit committees were doing that. So, how does the
engagement team exercise professional skepticism? That's a qualitative issue, and you hear that they want to use metrics but it needs to be done in context with other qualitative issues.

One area that Jay Hanson, my CPA colleague on the Board, and I have been really pushing with audit committees, and I think we're seeing some traction – and we've been pushing the firms on this a little bit, too – is how many hours are the staff working at the end of the audit, because that's a critical point where quality often suffers. And so, we're seeing firms move some of the work to a point earlier in the audit and having dialogue with audit committees about that. Jay Hanson found an article that said if you are sleep-deprived you are basically as impaired as if you are drunk, and that really resonates with audit committees. You don’t want drunk auditors. And I recently spoke at one of the big firm’s training for new seniors – these were the seniors where it was their third year, they all just got promoted, they just survived busy season, and I talked to them about this concept of drunk auditors. If you’re sleep deprived, you are basically going into the office drunk, and that really resonated with them.

It is interesting to see audit committees are now worrying about the staff working too many hours at the end of the job. So, we have some positive movements there. There is variability in audit committee performance out there, even across the big firms, the big companies. But I’d say, for the most part, the big companies who participate in NACD and in some of these other professional organizations are doing a good job.

The next tier of firms in terms of market size – we talked to them about how audit committees are working, and it’s a tough, mixed bag at the mid-cap companies. There are some very good audit committees, and there are some that really don’t have the expertise to oversee the audit. And for the smallest companies, we've actually surveyed some of the auditors that attend our small business forums on their interaction with audit committees, and their views on audit committee oversight, and I was just amazed at how candid those small firm partners and staff have been with us about the level of quality or lack thereof in some of those audit committees. So, across the different sizes of companies, I think there's still a lot of work to do. I’m glad that the bigger companies and the bigger firms are leading on this.

**CF:** So, Roger, picking up on what Jeanette just said – the interaction between the auditor and the audit committee – the dynamic there and how it might differ between larger-sized companies and smaller-sized companies – is there any research that has been done or can be done on that dynamic, or are there impediments that just make it very difficult to do that?

**RM:** Well, I've been distracted there for a minute just thinking how introducing alcohol might affect, or stimulate, the decision making process.

**CF:** I suspect there’s a Kansas State joke in there somewhere.

**RM:** I tell you, I just move to Aggie-ville and the problems solved. Well, obviously, what they described is a really interesting calculus, and that makes it very hard for researchers to make progress in this. I think this is right for what we call a field study approach – where we can't simulate this in a laboratory. We can’t take a simplified case and try to simulate what an audit partner is going through or what an audit committee member is going through. So, field basis
research is basically where we get agreement from parties to basically walk us through how this works, and we do this with interviews, we do this with observations of behaviors and outcomes, and things like that. That's a very difficult and long, live research approach, but I think that's really the way – at some point – we can make contribution to that.

But, also, as an educator – because the rest of the academics are also educators in the teaching sense – this is exactly why I jump up and down in front of my classroom – and I say this is why auditing is so cool – because this is really complicated. You know, we could pretend like auditing is all about that introductory textbook, and here's your forms of evidence, and here's your management assertions, and go out and do good in the world. And that's fine for a year or two, but that's a pretty boring view of auditing. I also don't want to scare them off and say this is all done behind smoked mirrors, because that's not true either. It's a very interesting buyer-supplier relationship where there are quality expectations and there are users of this output from the auditors. And I use this to motivate students – that this is a life-long type of learning process, and you have to learn some basic skills – the accounting and the auditing, the evidence, and the data management, and things like that – but you also really need to be thinking about what's going on around you.

And I think that's what I hear you guys and ladies describing. Let's not pretend this is objective and we’re simplifying this. This is very complicated, and the more we understand those nuances, the better off we're going to be. In research, we can only tackle one of those nuances at a time, so we're in there – I think we’re making contributions – but I'm not sure that we can get near the complexity that you all deal with in reality.

_JU_: And I have to tell a really quick story on this point about the ills of working the staff too much late in the cycle. This is not a new issue. We found in the archives a letter from Deloitte to a client in 1912 that accompanied the delivery of the reports. And, literally, the cover letter reads – please find attached these reports. As you know, the figures are off by twenty-six cents, but, as you know, the reports were prepared late at night under great duress. A hundred years ago – same issue – we’re making some real progress.

_CF_: Right.

_JU_: It just took a while.

_CF_: Right, what did you say that the next five years are going to exceed what’s…

_JU_: Happened in the last fifty.

_CF_: …happened in the last fifty years, so maybe there's more to come in the next while?

_JF_: Yeah, so working 22 hours a week, right?

_CF_: As opposed to 22 hours a day.

_JU_: That letter was actually written under a Kansas City office.
**CF:** There you go. Well, now I'm going to shift this to our third big topic area, and talk about some individuals that have been in the news – at last at the accounting end and auditing news – and I want to talk about ICFR. And then, also pick up a little bit of – on the topic that you touched on, Joe – about non-GAAP measures.

So, Jeanette, let me start with you. Over the last several years – in the PCAOB inspection process – there have been the citation of deficiencies in the audits of internal controls. In fact, I think so much so, that in October of 2013, the Board issued Practice Alert Number 11 that highlighted some of the areas around ICFR that you're seeing in the inspection process and some concerns that you had. So, tell us – where the status of the ICFR audit today? Are you still seeing the same concerns or have things improved?

**JF:** So, first I have to level-set us as to where we are in terms of our inspection cycle, because I always get confused as to which year I’m talking about, because there’s a lag.

**SM:** So do we.

**JF:** So, for the Big Four firms, the latest year that we've got public information out is the 2014 inspections, and those reports came out in 2015. We're done with the 2015 inspections, and currently preparing the reports – so those will be out soon, but I can talk a little bit about 2015 – just generally. So, I think 2013 was probably the peak year for these findings, and we did see, for three out of the four firms, a significant decrease in deficiencies between the 2013 and 2014 years – in the reports issued in 2014 and 2015. And ICFR findings were driving the overall audit deficiency rate in those reports.

So, of course, the ICFR deficiencies were coming down as well. I asked the staff to slice and dice these numbers so I could try to figure out any trends, and I couldn’t. And part of the problem is that we're only dealing with four firms – and each of the four firms were in slightly different places – and some not so slightly different – but were all in different places for the most recent year. There was still one firm that did have a fair amount of findings related only to ICFR issues, and so that was driving the numbers on the “ICFR-only” findings. Well, the good news there was that they were not also having extensive substantive audit findings in the same audit areas. And so, hopefully, if they can fix their ICFR findings, their overall results will come out better.

We did have one interesting trend, though. Between 2013 and 2014, the nature of ICFR deficiencies that decreased were those associated with testing design effectiveness and operating effectiveness. So, auditors are getting better at actually testing the design and operating effectiveness of the controls.

The deficiencies related to selecting the right controls to test remained constant, and that was an interesting finding. If you don’t pick the right control to test, it doesn't matter if get the other part right. We are expecting to see a further decrease in ICFR deficiencies across the board for the Big Four in 2015 inspections, and I haven't tried to analyze those numbers yet. But, the good news is – there's been a tremendous amount of improvement in this area. I will say, and
I’ve said this in other forums as well, I think in some cases these weren’t necessarily isolated auditing problems. They also involved ICFR design and implementation problems at the issuer – problems that the issuer needed to take care of. And that’s why the auditors were struggling. I think we’ve seen improvement across the system, and we’ll continue to see that.

**CF:** So, let's pick up on that point, though, about the issuer's design and implementation of their internal controls, and what that means from the audit perspective, and the difficulties that that can provide you all – particularly since AS 5 requires auditors to take a top-down risk-based approach to the audit of their internal controls. So, how do you go about assessing that – particularly if there hasn't necessarily been any error? What are some of the challenges that you all see? And I'm looking at Scott and Joe.

**JU:** I’ll go first.

**CF:** It’s your turn – to go first.

**JU:** I think it's important to start with the macro context here in terms of what is trying to be achieved – with the objective of what the legislation was when Sarbanes-Oxley was enacted. There is a tremendous benefit to the company having a robust system of internal control, and, ultimately, the process can't work in an optimal way unless there's an alignment between the company's implementation of its controls, the quality of the auditors that were around auditing the controls, and then the audit committee’s oversight process in its entirety. And, as we work to instill a very rigorous standard and achieve those benefits – there's obviously some bumps along the way. And, communication is absolutely essential.

What we found is that when we sit down with our clients, and we talk through what the objective is – and then, we come up with common sense ways in which they could meet the objective, and we can meet the objective – we get to good answers. When there's a big push late in the cycle – it’s already December, the company is trying to close its books – and then you come in suggesting there's a bunch of things that are, you know, that need to be modified – that that rightfully creates a level of consternation. So, getting that benefit early on in the cycle is critical.

The other piece of this – you mentioned Cindy – the objective is to take a top-down risk-based approach, and to focus on that which is important and material. And so, my own belief is that – for those controls that are most important – that sit atop the highest risk elements of financial statements, the most subjective estimates – having an increase in the level of effectiveness of the company's controls, the documentation of controls, the execution of those controls, and then elevating the level of our work that we do to make sure that the intricacy of those controls is appropriate – that's well worth the cost. Now, if you take that approach and try to peanut butter across the entire population and you start focusing on things that are less important, then you can understand where frustration would come in. So, communication early in the cycle and a focus on that which is important are absolutely essential. Maybe one comment on the whole issue of the quick factor – I can certainly offer some thoughts as well.

**SM:** Sure.
**JU:** But it is a particular challenge.

**SM:** Sure. And one thing I'll say is – our firm, I took my role in the firm this past July, and I was welcomed to the PCAOB report that is the outlier in what Jeanette was describing – the ICFR comments, and…

**JF:** I was trying to be discrete.

**SM:** It’s public information. In fact, it is one of the things I said to our leadership team is we're going to fix this immediately. Now one of the frank things I also learned, being a little naïve, is it's hard to change an audit firm immediately because the cycle is pretty long, but we've already been making significant progress. And I say that because – one thing I learned in this – just to build off what Joe was saying – you can't audit better than your client’s environment will allow. And one of the things that I’ve often had to really get my partners to get their head around is – let's make sure we're having those very difficult conversations.

Your skepticism starts at the very beginning of the audit by evaluating the environment and planning what you do. You've got to really challenge management where they're not doing it right in the right areas. We're not going far enough to make sure they are. And I’m not talking about material weaknesses – but I am talking about their willingness to come along and be part of the audit in a way that allows the audit firm to do the high quality work they need to do. It's one of these metrics we put in place to really measure how our clients are performing – and really challenging them to make sure they're getting better and we're getting better around that.

Now, having said that – to Joe’s other point – one thing that continues to be a challenge, I believe, is going ahead and calling a material weakness when the only thing you have is the control review and no other evidence, right? No, there’s been no audit adjustments, there's no passed audit differences. Having that conversation – that’s the one that really matters, right? Detecting the material weakness in internal control or a significant deficiency before there's any causes – well, the cause is known, but the outcome is not – is hard. Because, in essence, it's very judgmental, right? You’re calling management up and saying – I believe either the design of your control won't capture something that could be material – that could be a very, very difficult and judgmental conversation. Or, we agree on the design, but we don't think that way you've effectively executed it actually would have caught an error. And, again, we didn't find and error – so to get into that very difficult conversation.

But if you don't get this right, you're never going to get the audit quality side of this right – because you're always going to deal with the fact that – it's never a problem until you have some kind of failure. That's not the world we want to live in, right? We want to get into a world where helping our clients prevent failures, where we're making sure we're calling the issue before they become a problem – and if that means clients dealing with the disclosure of material weaknesses or having to make significant changes to their control environment before they’ve actually committed deficiencies, that's the way the world should work. But getting there is not as easy. It is a process of evolution, if you will – getting all clients to act with the same mindset.
**JF**: We know there was a pretty dramatic SEC enforcement case recently…

**SM**: There was.

**JF**: …on this very issue – where the contracted internal auditor detected some deficiencies, nobody was willing to call it a material weakness. There was a restatement subsequent to that, and the new firm that came in found fourteen material weaknesses, and the SEC went after everybody involved. They went after management, the internal auditor, the external auditor – so that's a very instructive case.

**JU**: It’s caught people's attention – as it should have. And this gets back to the very intent of the statute. Material weakness reporting was intended to be an early warning system that – even before there was a financial statement misstatement – investors would know there's something amiss that could potentially cause a problem that would ultimately impact their investment decision. And when you look at the research that's been done on the actual reporting of material weaknesses in the decade plus since SOX was enacted, the preponderance of material weaknesses are only reported after a material restatement – a material error – has been the detected. And so, it's backwards relative to the initial intent.

And to Scott’s point, this requires a mindset shift – it requires an approach by both the audit firms and the corporate community. But, we are seeing an increase in the instances of material weaknesses being reported upon in advance of the financial statement error. I can't speak to the statistics across the entire population, but, anecdotally, in terms of eyes that come across my desk, it's becoming more prevalent.

**SM**: Absolutely.

**CF**: So, Jeannine, is this hitting the boardroom?

**JS**: Yes.

**CF**: Do you have these discussions?

**JS**: We do. And I guess I think companies have the self-interest in getting their control environment in great shape because errors are costly. You know – whether the error causes some kind of problem. But, even a problem with the books, and you have to go to the street and talk about a significant error – that's costly to the company. So, they should have a strong self-interest in getting a strong control environment. As I mentioned in the company where they are in 45 countries – most of the problems that they had in the early days of the company were because of problems in their control environment. Maybe not the books, but for the control environment, they lost money. You can't afford that kind of thing.

So, I think you have serious reasons to want to bring down the number of deficiencies you have every year. And in the recent companies I’ve been associated with, we have brought them down every year. And we talk about that – how can we get to fewer numbers of significant? How can
we get to fewer numbers of other? Haven’t had a material weakness, thank goodness. But, how
can we keep bringing these numbers down?

CF: So, Roger, generally about academic research, some of the academic research that’s out
there. And I think there is both some quantitative and experimental research on ICFR – give us
a little flavor of what's out there in the research, and what might be coming.

RM: Well, certainly we're seeing the same lack of material weakness identification prior to
misstatements in research, and that's been true pretty much since the beginning of the ICFR
reporting. Jeanette, I can't remember where she gave a speech where you have a lot of statistics
on restatements versus the material weaknesses…

JF: Yep, AAA last year.

RM: Was it at the AICPA?

JF: No, it was the AAA Annual Meeting last year.

RM: The AAA – I encourage my academic colleagues to look at that speech, and that's an
interesting class exercise that helps students understand what we're talking about. Where she
gives the statistics where you can basically figure out how many companies are getting material
weakness reports and how many were getting misstatements after the fact, and the overlap of
those. And that’s really interesting, I think, for students to see the challenge of exactly what Joe
and Scott are talking about – and that is how do you know a problem could happen – because it
hasn’t happened yet?

And I think that research – at least my view is – you talk about a change in a mindset, but that's
a real education challenge, too. And not necessarily on-campus education, but how does that
expertise get developed in an auditor that the partner has? A partner can sit there, and anticipate
what bad things could happen, but I don't think a senior has a chance until they’ve seen enough
calamities to begin to piece together evidence that says this could lead to this bad outcome.

We know a little bit about how hard it is to do that with analytical procedures. We've done a lot
of research where we look for patterns – the ability to identify patterns in analytical procedures
that might indicate an underlying misstatement. I think the research might be moving in that
same direction. What is it that an auditor has to experience before they can say – well, given the
control design, here are the things that can still happen that are not very good? And firms are
challenged because you have to develop that experience under fire. In terms of us
understanding that process, I don't know that we have a really good insight yet into the firms
and that level of decision-making, but I think that would be very productive in the future.

CF: So, now I'm going to turn and talk more about the non-GAAP measures agenda you
touched on in your presentation. And, Jeanette, I'm going to turn to you first, because we just
had your SAG Meeting earlier this week, and you're fresh off of that, and I know this is a huge
topic of conversation. And one of the benefits of SAG is that you get the various constituencies,
right? You got audit committee members, investors, preparers, auditors, academics on the SAG.
What was the nature of the tenor of the discussion, and what are same takeaways that we should think about?

**JF:** It was a very interesting discussion – and we also discussed it at our November SAG Meeting as an emerging issue – but we did a deep dive over the last two days on it. And we heard this morning about the proliferation of the use of these numbers. The use of non-GAAP measures is increasing; and it's all kind of going in one direction – and people are getting more creative about how they are using these. And so, that's also caught the SEC's attention.

And the SEC – just this week – updated its compliance and disclosure interpretation on non-GAAP measures. They've become very clear on specific examples of types of non-GAAP measures that may be misleading; whereas, before the guidance was more open-ended – and that allowed for some of this creativity. The SEC also included specific examples of when the staff will consider a non-GAAP measure more prominent than GAAP. The SEC staff presented at the introduction to this section of the SAG Meeting, and sent a strong message – saying that the SEC will start challenging these measures. There will be more comment letters, and companies should self-correct this quarter. So, the SEC is coming out pretty strong on this. They also said that the SEC intends to curb some of the bad practices associated with non-GAAP measures.

The SEC is doing what it needs to do, and that's where this effort should start. We had discussions about what the auditor’s role should be. Should there be assurance over this? Should the auditors be looking at it at all? And I think the biggest concern that came up was the difference between whether these are included in 10-K filing – in which case the auditor has to read and consider under our current standards whether there's some material misstatement of fact or whether they’re materially misleading. And those same measures, if they're put out in other types of communications – like press releases and so on – even though these later get furnished, for the SEC they're not filed – so they don't come under the auditing standards. We had a lot of discussion about the potential for our auditing standards to be expanded in scope to address the furnished information.

I think the general consensus was that we all need to stay on top of this. Right now there's really no rule-making role for the PCAOB, but we should keep our eyes on it and see how practice changes. I thought the one suggested change – for just bringing some of this into the read and consider requirement under our auditing standards – might be an interesting proposal. But, as Joe mentioned, there's no real framework for presenting this information. You can't really audit this – so it would have to be under the read and consider – and that's already a mushy standard. So, we're going to keep our eye on this.

**CF:** And so, I want to get to the practitioners’ point of view on all of this. First of all, is any use of non-GAAP measures – any of this in the control environment – in the ICFR audit? Jeanette mentioned the 10-K?

**SM:** That's probably one of the biggest questions audit committees should be asking. Because, it’s mixed. Some companies have very strong controls around non-GAAP measures. And if you think about it, logically, if you're going to tell the market that way – that these are the most
important measures that I use to manage the business and, in fact, that I use them equally – usually they have to be able to say – because they need to to comply with a rule with other measures when I disclose them – the next logical question is – okay, well what controls do you have around them to make sure, when you report them, they’re accurate?

And some of them are fairly obvious and easy because they are adjusting earnings for certain items, and hopefully the companies do have good controls. Others are operational statistics – a lot of companies would say it’s more important we know, for example, my sales and not my audited revenue. If I have long-term sales contracts, you know – that the flow, the pipeline of new sales orders – that's more important. Well, okay. What controls do you have around what you’re reporting? What systems does it come out of? Etc. Several really important questions.

I also think that one of the difficulties about non-GAAP measures is, in some sense – and Joe said really well today – the notion that people want different, more current, more relevant information is true. And you can't cut that off. On the other hand, the question really isn't as much about the accuracy of the information, I think. It's the context of the information, and can I as a reader really understand the context of what you're telling me? Or, are you spinning to me? And it's hard – I don't care how smart you are as an investor – it’s pretty hard to know what the motive is and what management is trying to do. I will say that a red flag that I would look for is how often do you change the composition of your non-GAAP measure? If every quarter, you're adding a slightly different tweak to it – that feels a lot like you're trying to continue tell a story. And you laugh a little bit, but there are companies that periodically keep updating those measurements.

And I will also, last thing I’ll say – there's a herd mentality. That I'm in an industry and my five best competitors have that thing and they adjust for that particular item – like the fair value mark on derivatives, because that doesn't really count in their earnings. Well, I got to do the same thing is not that unusual. So, I think those are things that audit committees and others need to stay focused on, because it really is a difficult area, quite frankly.

**JU:** It comes down to a race to the lowest common denominator. I think from a technical standpoint, if we accept that these measures are being reported in the 10-K, they arguably do fall within the company’s obligation to certify their disclosure controls and procedures – which is a more expansive population of controls that ultimately is audited. It’s more expansive than the internal control over financial reporting; but nevertheless, companies should have their own controls to support their certification. If the numbers are reported outside of the 10-K, then they're arguably under the statutory requirement for controls to be applied. But, we've seen a significant increase in the focus of audit committees demanding that company management have as robust a system of internal control over the preparation of that information.

In terms of our requirement – so, as Jeanette mentioned, if something is sitting in a document filed with the SEC, under the current audit literature dating back to SAS 8, we have an obligation to read and consider it, and to do something if we conclude that it's materially inconsistent with the financial statements that we’ve audited. You used the technical term mushy – which in spirit – so if a company reports a metric, and it’s earnings before nine different charges, but those charges which were taken from the underlying financial statements,
and they equal the amounts from the financial statements. We can argue whether it's a good metric or a bad metric, but it's not inconsistent with the information in the financial statements.

And so, the technical obligation of the auditor, in that case, is somewhat limited. We've had more and more audit committees say – I don't care whether you're technically required to be reporting on this or not, I want to hear what you think. So, I want you to look at it, and if there's something that looks out of bounds to you, you need to sit here and look me in the eye and tell me. And that's certainly an effective mechanism. And, there's shades of just how far astray some of these measures have become.

So, last week, I was sitting in an audit committee meeting, and there was a discussion that centered around some of these metrics. And one of the audit committee members looked across the table and said – these aren’t non-GAAP metrics, some of these are anti-GAAP metrics. And so, we looked at him and said – what do you mean anti-GAAP metrics? And so, there are certain adjustments that are being made and are not just stripping out a particular item and non-recurring, but they’re actually changing the basis of accounting. The accounting rules have a certain measurement and recognition framework – it tells you to take the revenue and spread it over time – and the non-GAAP metric is actually undoing the accounting principle, and putting back in as if you followed some different accounting principle. And that's one of the things that the SEC highlighted…

**JF:** Right.

**JU:** … in this CE&I interpretation this week – as out of bounds.

**JF:** I hope that the SEC guidance helps the process. The advice that I would give to audit committees is – ask your audit firms, if appropriate in the audit, how do our non-GAAP measures that we've been using stack up against this guidance? And do a good scrub down, and hopefully the firms will also be telling the audit committees that they need to do this. And, you know, we’ll have to monitor this.

**CF:** So Jeannine, are you having more of these kinds of conversations in the boardroom?

**JS:** Yes, and I think that the audit committee should be asking – why are they using the information? Is it something to help the investor understand the business better? Is it what we're using internally to understand the business better? So, and does it tie? And we use numbers on the boards I'm on – where they tie-back to the financials. I mean, you can see the numbers that we either take out or put in – in the financials. They’re in various places – they’re audited, very auditable. And, in those circumstances, I do believe non-GAAP makes a lot of sense. I think it has to be consistent. I wouldn't understand any numbers that changed or where we change the formula quarterly or even annually. When we have changed it after a couple years because you found something better – that’s different. But you can't just go back and forth to what looks best this quarter.

**JF:** You know…
JS: It doesn’t make any sense.

JF: There was one very interesting investor analyst perspective in one of our closed meetings. That was – no, I don’t want this regulated. I love seeing the messiness that these people put out, because I can judge the integrity of management by what they are…

JS: Yeah – right.

JF: …doing with these things.

JU: Great point.

JF: It was really an interesting perspective.

JS: Yeah, right – that’s probably true.

JF: Yeah.

JS: And, I think that’s a case where you go overboard with it. I mean, if people go overboard, you start wondering, too,…

JU: Yep.

JS: …what exactly are they trying to do?

CF: So, I have a lot more questions that I want to ask the panel, but I think this is the part of our session where I’m going to open it up to the audience. I want to make sure that we leave some time for you all to ask questions. So, any questions for the panel?

Questions and Answers

CF: We’ll start here.

What I’m listening to right now is that you have to read and consider information to determine if it’s materially inconsistent with what’s reported in the financial statements. And say if a non-GAAP measure takes seven exclusions with all the exclusions tying back to the financials – then it's not inconsistent. But that's only the quantitative side of materiality.

Has anyone argued that on the qualitative side? For example, in the audit, anything that turns a loss into a gain is universally considered qualitatively material. Well, if your non-GAAP financial measure ties back to the financials, but turns a loss into a gain – that’s materially inconsistent with the financials.

JU: I mean, these are exactly the questions that are being debated right now. To start with, many of these metrics fall outside of the 10-K, and therefore they never even get into the realm of this dialogue. To the extent that they do fit within the 10-K – the auditor has to make this determination. Again, it's not a question of whether the numbers materially differ from the
financials – it's a matter of whether it's materially inconsistent with the financials, and the
preponderant interpretation to date has been that if these numbers are transparently disclosed –
in terms of what's in or out – and they tie back to the financials.

Let’s just say that the income of the company on a GAAP basis was a hundred, and there was
two hundred dollars of stock-based compensation – and it's very common that some companies
in certain sectors report a non-GAAP metric that excludes stock-based compensation – and
when you back out the two hundred of stock-based compensation it turns the number to a one
hundred loss. The two hundred is an audited number that is sitting in those financial statements,
and the use of it is not materially inconsistent with those financial statements. Now, if the
standard were different – if the standard was, you know, does it produce a materially different
outcome in the financials? Maybe you’d get to a different judgment. Right now the standard is
– is it materially inconsistent?

SM: I think the other thing to remember – or to think about – is what is the SEC guidance to
management on non-GAAP measures? And, up until the recent discussion, it really was pretty
straightforward. It was – it can’t be materially misleading, it can’t be any more prominent than
the GAAP information that you're presenting, and you have to reconcile it. And, basically the
SEC learned, and would say – if you do those three things, you're within the provision of the
rules.

So, as an auditor, basically, when you apply that standard, it would be hard for us to say – yeah,
but you know what, we really just don't like that particular disclosure because it just doesn't feel
right. Given that that's what the rule says – and that's part of the issue. I think that's where the
audit committee becomes really important, though. That's where you have a conversation – a
very open conversation – with the audit committee, and say – look, this is totally appropriate in
the sense it follows the rule. It is not materially inconsistent with the financial information
that’s presented. But, I will tell you, that you're an outlier compared to what I would think is
good practice in this area – and really ought to challenge management and understand it. Now
frequently – I really haven't found that the case very often – but when it is, you've got to be able
to have this conversation.

JF: And I think that the new SEC guidance will also help identify certain types of items that
shouldn't be…

JU: Yes.

JF: …used.

JU: Right.

SM: That would be helpful…

JU: Definitely.
**SM:** …because it will narrow the field at least to take away some – I would almost call them – egregious, if you will.

**CF:** Yeah, and another, I think, ripe area for exploration – and could give us a little more insight into this – is the SEC has a Concept Release out right now on Regulation S-K that gets into some of these issues, too. And while I don't think the SEC is going to do anything with all the information they gather, the comment letters that they receive might be instructive, and might be an area to explore what some of the issues are – and might even lead to ideas for research.

**JS:** There’s a lot of questions.

**SM:** It’s going to take a little bit of time.

**JS:** Yeah.

*Really enjoyed this panel this morning. I really appreciated Roger Martin’s bringing up the question about how we educate students on recognizing that a problem would happen before the problem actually becomes found. And, basically, I see this as a pattern that could represent a problem. And, I play a lot of chess, so I know when my king is in trouble – that that presents a problem. So, I think, from my own experience as an auditor, the best way to develop the given ability is actually working on – not smooth but – messy audits. That’s how you develop the experience.*

*So, my question is to Joe and Scott. What are the firms doing into simulating these messy audit scenarios in their training, because that’s where I think you should be doing it.*

**JU:** It's a tremendously valuable tool. So, we've actually taken earlier audits that have been messy -- audits that have been inspected by the regulator where deficiencies were identified -- and we sanitize them and put them into case study format. And that served as the underpinnings of a significant amount of our training, because you don't learn a lot going through an audit where everything's been done right and found nothing. You learn a lot by going through the messy situation and having to make the real world judgments, and take a stand, and push back, and refuse to issue until the underlying matters have been corrected.

And that's actually – and, Scott, you mentioned earlier on the panel – one of the great PR challenges of the profession. In most professions, the public can see both the good and the bad. They know when a profession messed up. You can also see the airline that got you there or the drug company that helped cure somebody – either themselves or with the help of somebody else. With the auditing profession, the only thing that ever really gets seen is the stuff that went wrong. And when we stand up, and we do the right thing, and force the particular issues to be corrected before the numbers go out – were precluded under the professional standards for making any mention of that publically. Were bound by confidentiality, and so it really is a difficult spot to the end of my PR standpoint.
SM: And I would just add, I think we’re doing exactly the same. The one thing we're really looking at is scaling – we do it merrily now, but making it scalable – which is truly doing experiential or simulation irk-mines, where we’re putting the young senior in an environment where it's basically – here’s the pattern, and we're making it intentionally go down that path, right? So, we're trying to help them learn about scoping a large, international engagement – which areas they should audit? We know that that's a challenge for a lot of teams, and we're simulating certain information where it’s going to be very easy to miss a very important fact. And, as a result, is going to be an audit failure – and, as a result, is going to be a messy thing. And, hopefully, they catch it. But, if they don't, they’ll learn even more from the fact that they went down that path, and have that experience. So, that's one of the things that we’re trying to scale, if you will.

CF: Okay – one more quick question. Right over here – you’ve got the microphone. I hope you don’t mind, I’m sorry. Go ahead, you’ve got the microphone.

Can everybody hear?

CF: Yes.

Yeah, this is basically a follow-up question to something that Joe mentioned in the earlier session, but I think this is a question that can be posed to any of the members who choose to answer it – which relates to – Joe mentioned about the benefits of having CEO, CFO certification of the financial statements on issues like fraud and so forth. And I just wanted to draw an analogy, give a perspective on each partners’ signature on the audit report.

Now, there are, of course, regulatory disclosures that can be made in identifying the engagement partner, but I wanted to get your input – as well as the panel members input – on whether there’s any incremental benefit of audit quality of actually having engagement partners sign as many other parts of the world – and many other capital market – they do, and they have found benefits associated with that.

So, I was trying to get the analogy in terms of not just the disclosure versus signature – and whether audit quality in the perception or in fact – in terms of the processes that go into the conduct of the audit – changing as a result of some of the action of putting the signature on the audit opinion.

CF: I know you directed the question at Joe and Scott – I’m actually going to redirect it at Jeanette as the PCAOB has just issued their new standard on partner identification, and, in fact, the SEC has finalized that rule – so that is going into effect. So, give us your perspective on that question. Was it done to improve audit quality or were there other reasons that the PCAOB put that forth?

JF: That’s actually a very messy question and, that's why it has taken so long to get this thing out. The ACAP – the Treasury ACAP report in 2008 – had a recommendation to the PCAOB – the ACAP was the advisory committee on the auditing profession to U.S. Department of the
Treasury – a recommendation that the PCAOB look into whether the auditor should sign the report.

And, because of the liability scheme in the United States, it became very problematic for auditors to actually sign the report. So, unless the liability issues could be fixed, and we at the PCAOB could not fix those – we decided to do something that was within our control. There seemed to be a demand for, at least, disclosure of partner names, since this is available in other countries – and so we went down this path of disclosing through a form. And we'll see what happens. Some of the research that was done in other countries I don’t think was really relevant to our environment. So this might be a good experiment for researchers going forward, and I'd like to see us do a post implementation review on this particular requirement to see what kind of benefits we gain – or not – from this.

I will tell you I spent twenty-three years of my career at GAO where we signed our audit opinions. And we were in government – so nobody was going to sue us. I did sign a lot of opinions, and, yes, it does focus you, but there were a lot of very high profile audits that I did where our Comptroller General wanted to be the one signing rather than Jeanette Franzel. So, I was heading up some audits where the Comptroller General signed. I was equally focused on quality in both of those situations – whether I was signing or whether the Comptroller General was signing.

CF: Okay, I'm sorry to cut this off, but I do want to be respectful to the rest of the program. So, I'm going to ask all of you to join me in thanking Jeanette, Jeannine, Joe, Scott, and Roger.

1 Transcription Note: The original transcript has been edited for flow and ease of reading. Any changes to content were not intended to change the overall message associated with the applicable discussion.