

Deloitte Fireside Chat – Part I
The Role of Professional Judgment in Accounting and Auditing
October 22, 2009

ZOE-VONNA PALMROSE: Good afternoon and welcome to today's Deloitte Fireside Chat Part I on the Role of Professional Judgment in Accounting and Auditing, broadcast live on www.sechistorical.org, the virtual museum and archive of the SEC Historical Society. I am Zoe-Vonna Palmrose, PricewaterhouseCoopers Auditing Professor and Professor of Accounting in the Marshall School of Business at the University of Southern California and moderator for today's program.

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Today, I am delighted to welcome Gregory Jonas, who serves on the PCAOB Standing Advisory Group, and was a member of the SEC Advisory Committee on Improvements to Financial Reporting; and Robert Kueppers, Deputy CEO of Deloitte and a trustee of the SEC Historical Society. Our conversation today will be an interactive one, exploring the role of professional judgment in accounting and auditing. Before we begin the program, I would like to state that the views of the presenters are their own and do not reflect those of Deloitte or the SEC Historical Society. The Society is responsible for the selection of the moderator and the presenters.

Our discussion today will be guided by questions suggested by the presenters, by a planning team from Deloitte including Lauren Bonn, Consuelo Hitchcock, Misty Jenkins Saldi and Raymond Lewis, and by questions submitted by visitors to the website prior to this Fireside Chat. Our session recognizes that the meaning of professional judgment and its application in accounting and auditing have become subjects of interest and discussion for standard setters, preparers, auditing professionals, investors, regulators and faculty and students alike. The SEC's Advisory Committee on Improvements to Financial Reporting, also known as CIFIIR, which issued its final report in August 2008, represents the latest in a series of public policy initiatives to focus on professional judgment in accounting and auditing.

So let's begin with CIFIIR. Greg, you served on this SEC Advisory Committee, why did CIFIIR take on the issue of professional judgment?

GREGORY J. JONAS: Zoe-Vonna, it's a pleasure to be with you here today. And let me say that like many recommendations, they begin with perceived problems and the recommendation is trying to cure the perceived problems. I think the CIFIIR Group

identified five or so things that gave us cause for concern that we thought a judgment framework could help. These are, for example, many re-statements that we perceived resulted from deemed errors in judgment. Second, we heard from regulators that they believe that there are many cases of unpersuasive or under-supported judgments being made by practitioners. Companies and auditors told us that they believe that, from time to time, regulators did not respect their reasonable judgments and they substituted the regulators' personal preferences for reasonable judgments in requiring revisions to financial statements when citing audit deficiencies. So you can see there is somewhat of a mistrust here between, on the one hand, preparers and auditors, and on the other hand, the regulatory community on the subject of judgment. The fourth concern that we saw was confusion in practice as to what constitutes a persuasive judgment. Really in the auditing literature and the accounting literature, the profession really has never addressed what are the qualities of a persuasive judgment. And then finally, we see a demand for detailed rules as a substitute for professional judgment, which undermines the goal of principle-based standards. So, there's kind of a defeatist self-reinforcing bad loop here of practice demanding ever more detailed rules, so that they won't be second-guessed by overseers about the quality of their judgment. So, for all these reasons, these are the problems that we saw.

We thought that a judgment framework could then serve the following goals. First and most importantly, I might add, improve the quality and reliability of the judgments that are made in practice. Second is to improve an auditor's confidence that regulators will indeed respect reasonable judgments. Third is to establish criteria for judgments and thereby reduce uncertainty about the characteristics of sound judgment. In other words, clarify what people are looking for from judgment. Then finally enable principle-based standards. So these are the important goals that we had in mind.

ROBERT J. KUEPPERS: Zoe-Vonna, let me add to this fundamental question of why did the committee take it on. I have to tell you, I think the CIFIIR group's willingness to take on the tough issues, the quality of its work product and the fact that many of its recommendations were very operational, or things that you could make operational speak to the quality and the really fine work that that group did. And as I look back at the roster of talent and the willingness to take on things others have decided are too complicated, speaks volumes in terms of what a good body of work that really was.

ZOE-VONNA PALMROSE: Well, listeners ask that we probe the distinction between judgments and decisions. Bob, what do you think CIFIIR means by judgments and do they differ from decisions?

ROBERT J. KUEPPERS: Actually, that's an excellent question because, maybe it's sort of like a continuum: there're decisions, there're judgments and then there're professional judgments, in my mind. It is true that all judgments, professional or otherwise, would be viewed as decisions, but not all decisions necessarily involve judgment. What we should be talking about today in this session is about the professional judgments, because those are decisions made against the backdrop of professional education, training and specific experience in a field. I think that, importantly, the context if you're an auditor, which is the perspective I bring here today, involves this whole notion of due care, objectivity, integrity, skepticism, independence. So, it's in that context of making a judgment about a professional matter, whether you be a company or an auditor, that I think distinguishes professional judgment from everyday kind of decisions we make all the time.

GREGORY J. JONAS: Let me pile on a little bit by agreeing with Bob that this is an interesting question. But I don't think that CIFIIR ever addressed the distinction between a decision and a judgment. I think what we had in mind with judgments are things that involved important matters, big material items, where difference in judgment would create very different-looking financial statements. Second, characteristic of a judgment is there are reasonable alternatives that could have been selected, and which one to pick is somewhat uncertain. So it's this range of possibilities that constitutes the need for judgment, whereas some decisions are just obvious; there is only one answer. Here we are not talking about one answer; we are talking about a range of reasonably possible answers. So, there is some controversy to a judgment. Reasonable people can look at the same set of facts and get different answers, and so we are talking grey-area type areas. That's what I think CIFIIR had in mind when we wrote this.

ZOE-VONNA PALMROSE: That's what they called professional judgment. CIFIIR's final report contains some recommendations that are related specifically to professional judgment. Greg, maybe it would be useful at this stage to give our listeners a brief summary of these recommendations.

GREGORY J. JONAS: Zoe-Vonna, there are three broad areas in these recommendations in the judgment framework area. One is that the SEC should adopt a judgment framework for accounting judgments. I am sure we will talk about this more in a few minutes. The PCAOB should also adopt a similar framework with respect to auditing-related judgments, and that importantly this guidance from the SEC and PCAOB should be done in a way to take care, that we implement it in a way that does not limit the work of auditors and regulators to oversee and to second guess judgments. There is no goal here of trying to reduce people's ability to second guess.

ROBERT J. KUEPPERS: I don't want to disagree, Greg, but I will tell you that I think a lot of the impetus behind making certain that CIFIIR waded into this whole area and came up with this recommendations, had to come from the preparer community, the corporate community, the folks that prepared the financial statements. If you look at the backdrop of unprecedented numbers of restatements, working with clients all the time, I would say 20 years ago they would have not necessarily accepted a suggestion from the regulator who was reviewing the filing that they should process a restatement. They are more likely to do so now, partly in the belief that they are never going to win on the issue; they in fact are being second guessed, and the folks they are being second guessed by sort of held all the cards. I agree with you. It is vitally important that these recommendations come forward. But I think a lot of it came from a certain amount of frustration on the part of the corporate community, the preparers of financial statements feeling like they needed a place to stand that they feel was safe ground.

GREGORY J. JONAS: Bob, certainly we did hear that from the preparer and the auditor communities.

ZOE-VONNA PALMROSE: Let's pick up on this recommendation for the articulation of a judgment framework. So what would be the concepts that support CIFIIR's proposed judgment framework?

GREGORY J. JONAS: One concept is that the judgment framework would not and should not eliminate debate. This isn't about narrowing choice, eliminating debate. It's

about trying to improve the quality of judgment. A second concept is the framework organizes analysis and focuses preparers and others on areas to be addressed and thereby it improves the quality of judgment, and the likelihood that auditors and regulators will accept the judgments that had been made by practice. Another concept is the use of hindsight to evaluate a judgment, where use of relevant facts were not available at the time in the initial release of the financial statements is not appropriate. So hindsight with 20/20 with new facts only available recently is really kind of out of bounds with regard to the judgment framework. A corollary to that is that those who evaluate judgments should evaluate the reasonableness of the judgment and should not base their evaluation on whether the judgment differs from their personal first choice. So this is what is the ballpark of the range of reasonableness and is the judgment supportable in line with the criteria that we will talk about in a few minutes.

Importantly, we do not have the notion that the framework would be mandatory. This is not a mandatory framework. That is choosing to not follow the framework would not imply that you made an inappropriate or weak judgment. And finally, the framework is used on a very selective basis. It is intended, as I mentioned earlier, for major sensitive complex or highly uncertain judgments. I think it would be overkill for the many of the thousands of judgments used in the preparation of public company financial statements to apply this full framework.

ROBERT J. KUEPPERS: Greg, some of those points really resonate with me because I think a lot of what we are talking about feels a little bit like “Back to the Future.” This notion of a framework is largely a disciplined approach to common sense. You need to get to an answer. It needs to be a good, solid answer. We all have our own remembrances, but 20 years ago, when I was working at the SEC, if a company whose financial statements were being challenged came in and they had in their view substantial authoritative support for their position, it was often the case that the staff would suggest that, while they may not prefer that accounting, their job was not to put their preference over that of a company if there were two ways to go. Rather they would suggest that the company reconsider their accounting in the future. The notion of restatement got out of the room pretty quickly if they had that support. So part of this feels right to me because it totally aligns with the world that I grew up in as a professional. I feel like we have gotten away from it now, and we are now getting back to real fundamentals.

ZOE-VONNA PALMROSE: Let’s talk about what CIFIr actually suggested in the final report, which we should mention is available on the SEC’s website; the final report and the draft reports are available to the public. CIFIr did suggest some details on the components of a judgment framework and I may be recalling this correctly, that the final report actually has about 11 or 12. We probably don’t have time to go into all of them. Maybe Greg, you could give listeners just a flavor for what these components are.

GREGORY J. JONAS: The framework has two main sections. One is about developing a critical thought process and the second section is about documenting what you have come up with. The critical thought process itself has 12 components to it and a component is an area to be considered when making a judgment. Most of these components, and I agree with Bob’s observation, “Back to the Future,” some of it common sense. I think most of the components are indeed obvious and are widely used already in practice in making accounting judgments today. Let me give you some examples that we routinely see. Analysis of the transaction and related facts, analysis of

applicable accounting literature, disclosure in financial statements about the judgment or estimate consistent with today's reporting standards, and input from people with an appropriate level of expertise and then giving judgment in an appropriate amount of time and effort at the right point in the accounting or audit process. I think these are examples of the 12 that people would nod and say, that's just intuitive, that makes sense, that's no earth-shattering news here.

Documentation being the second main component of the framework, the notion here, and again I think this is widely understood in practice is that the documentation should be made at the same time as you are making the judgment and in no later than the release of the financial statements. It always frustrates, and I think rightfully so, those who oversee judgments to see documentation being made the day before because you got called in to account for what your judgment is. All of a sudden the documentation shows up, it just calls in question about whether indeed you had thought it through at the time.

ZOE-VONNA PALMROSE: Taken together, let me just ask, do these components represent a process for reaching sound judgments? What I am really trying to get at here is CIFIIR suggesting that those who might second guess judgments, say, for example, regulators or even auditors focus more on the process for reaching a judgment, and less on the judgment itself?

GREGORY J. JONAS: This is a really important question you asked, Zoe-Vonna. I want to emphasize this that what CIFIIR had in mind for components is not a process. Processes can be flow charted, processes are things that you input data, you follow a decision tree, and at the end comes an answer and that's not what this is at all. Rather they are areas for consideration that any reasoned judgment can be more persuasive if the following areas are thought of when you are making the judgment. That's all that this is. I don't want to make it sound like its some sophisticated rocket science thing. I would observe that I think second guessing is a healthy part of any well controlled process and the goal of this framework is certainly not to restrict second guessing, rather it's to improve judgment quality and thereby the acceptability and credibility of the judgment with those charged with second guessing them. So it's more than likely that regulators and overseers will accept the judgment made if the judgments have considered the criteria that CIFIIR has outlined.

ROBERT J. KUEPPERS: I am struggling a little bit, because Zoe-Vonna, you referred to auditors as second guessers.

ZOE-VONNA PALMROSE: Just to be provocative.

ROBERT J. KUEPPERS: I guess we could be viewed that way. But Greg, I take your point. I think that to suggest that this is a mechanistic approach completely undermines the value of this framework. It is a logical approach. It's one that, depending on the issue at hand, certain elements may take a very small role and others maybe expanded. It would vary depending on what it is that you are trying to reach a decision about, and I think that's the point. It's got to be extremely flexible. I would tell you that I think when it comes to SEC enforcement cases against companies or auditors, PCOAB enforcement cases against auditors, and some of the regime of inspection that were used to in the last six or so years in the public accounting profession, I think it should reduce the number of times, hopefully, that there is a disagreement or that there is a kind of a

gridlock in deciding what's acceptable and what's not. You are saying that it's not designed to reduce second guessing, but I think if arguments are equally viable - in other words, you are defending a judgment because you have followed the framework and others are questioning whether that judgment is sound - you could end up in a tie. And the way I like to think about it is maybe the tie should go to the runner, in this case the runner would be the company preparing the financial statements or the auditor whose work is being questioned. We often say when we are working with the SEC on questions and issues of clients that sometimes getting to a tie is not a bad place. So I think there is something more that we should explore a little bit further about the whole notion of second guessing. At least that's my sense.

ZOE-VONNA PALMROSE: Greg, you said that some of the components seem obvious, but then that must mean that others might be more difficult to meet and may not be consistently applied in practice today. Would you have thoughts and maybe, Bob, you have thoughts on this too, on which components might be more difficult or perhaps new to practice?

GREGORY J. JONAS: I think some are more difficult as you mentioned and here are my favorite three. First is to articulate not only what you have decided, but what was in the running that you have rejected, the so-called alternative views, including the pros and cons for those views. And the reasons for these alternatives and the reasons they were rejected. So in other words, justifying a judgment to someone is much about what you didn't pick as it is about what you did pick. And on the stuff you didn't pick you need to outline why it was in the running because chances are your critics felt that, that was their best choice what you have rejected. So you have got to outline why it was in the running in the first place, acknowledge its merits, and then explain why it is that you didn't pick that one, that you picked another one, that its pros and cons outweigh the one that is probably somebody else's first choice. So I think this is... when folks document and discuss their judgments, they almost spend almost all their time on what they chose as opposed to what they didn't choose. So, that I think is tough.

My second tough area is to explain your rationale. That's not new, but here's the hard part. Including the linkage of your rationale to two things, link it to investors information needs. So, I see a lot of judgments justified on what I call internal baseball which are factors that are internal to the company or internal to the audit firm. For example, I didn't have the data readily available, so I chose an alternative that I had data available that I could plug and play, for example. Or the cost of what alternative greatly exceeded the cost of another, so I rejected the one with the high cost. Those are very important points but I call them internal baseball points. This linkage point I am making is, you link to what's in the best interests of investors. Now, not always would you pick that particular one, there maybe times when it's just not at all practical to pick a particular alternative even though if you did have the data it might even be better for investors. But at least think about the investors and what would be best for them. I don't really see that done all that much today.

And then the second linkage in this rationale that I think is tough is link what you are thinking to the judgments of competent external parties. So, for example, if everybody in practice is following the tastes-great method of an accounting issue and you have decided less-filling is the way to go, I think you are going to have a hard road with regulators, because consistency of practice and comparability financial data is important. So, I think this linkage notion to investors and then the judgments of competent external

folks is something that gets you out of internal baseball and it's hard to do. I find myself liking internal baseball more than I am liking external linkage in my own personal judgments and it's just hard to do. But I think it's the thing that brings credibility and competence to a judgment.

The third on my wish list is, or on my difficult list I should say, is the reliability of assumptions in the data used. I see in some big judgment areas that people almost take for granted that whatever data the company has available or whatever data the system might have spit out is a credible starting point for the judgment and they don't often say, wait, wait. How do we know this data is any good? Garbage in, garbage out, so really scrutinizing the data to make sure it's of the quality of the analysis that goes into the judgment as a starting point if something is useful. So those are my top three tough areas.

ROBERT J. KUEPPERS: Greg, those are actually excellent points, because they put really a sharper focus on the elements that are most difficult. I would point out that as I was listening to you, it occurred to me that for most companies who have really worked hard over the last 5, 6, 7 years on the ability to have appropriate technical consultative resources within their organization, they are so much better today because of [Section] 404 [of the Sarbanes-Oxley Act] frankly - in terms of documenting, putting together an initial technical paper about a tough issue that they are facing - in part because they would be at risk without adequate internal resources to determine their own accounting answers. But my point is that the distance they would have to travel from where they are today to compliance with this framework - if we said it was ready to go, here we go, let's use it - is so much less than it would have been pre-Sarbanes-Oxley. For example, I think we are seeing our clients being much more deliberate in their approach to answering those questions. But the point you raise about assumptions and data, I mean all those, there is always room for improvement and I think this would take it, sort of, to the next level. But I think a lot of companies are well suited to live in a world like this.

ZOE-VONNA PALMROSE: We should probably emphasize that the CIFIIR recommendation actually calls for the SEC to articulate this framework for accounting judgments, and that this judgment framework then would be issued as a policy statement from the Commission. Greg, why did CIFIIR think such an SEC policy statement would be helpful?

GREGORY J. JONAS: Because of the regulators' enforcement authority and their ability to take tough action. Obviously what regulators think heavily influences practice. And so, transparency by regulators in how they evaluate judgments, both helps practice understand expectations, and it is also likely to strongly influence practice in the direction of whatever guidance the regulator chooses to issue. A policy statement is a statement by the Commission, as opposed to a statement by the staff like a Staff Accounting Bulletin. A formal statement by the Commission is likely therefore to influence staff behavior within the Commission and across the Commission. So it would influence Corp Fin in the comment letters, it would influence the Office of Chief Accountant when they get into accounting issues, and help Corp Fin think through what's acceptable and what's not. It would also influence Enforcement, and how Enforcement looks at the world. And it would do so more than if the guidance were issued by just the staff of one of those divisions, for example. So we thought that a Commission document was useful. And also a policy statement isn't mandatory rules. It's a policy. It's here's how the Commission looks at certain things or here are factors the Commission considers when

considering the qualities of a judgment. And so we don't want the judgment framework to be a rule binding as I mentioned earlier but yet we do want it to be something that regulators can use because it will influence practice in the interests of the public interest.

ROBERT J. KUEPPERS: So, let me just jump in there because the beneficiaries of a policy statement are actually pretty broad, not only does it drive a direction to the staff of the Commission itself, but then reporting companies, auditors, attorneys, others that work with staff all the time would have knowledge and see this framework. They should expect to work with it as they go forward and it doesn't suffer the burden of the Commission telling people how you must make a decision. I think the Commission has shied away from that - fundamentally telling people that you have follow and lock step some approach. So it gets the best of both.

GREGORY J. JONAS: I agree, Bob, and there are some examples we are in the CIFIIR Report of previous policy statements made by the Commission that we thought met the criteria that you outlined. It had the win-win advantage that you just alluded to and that's why CIFIIR became enamored with this concept.

ZOE-VONNA PALMROSE: But in all honesty, while the CIFIIR recommendation has garnered much support, it's not been without controversy either. I can remember when CIFIIR first proposed it in a draft report, there was a good deal of push back. Why was this so?

GREGORY J. JONAS: Zoe-Vonna, there were three reasons why I think the critics criticized what we were thinking. One is that they felt that it could undermine legitimate second guessing by regulators and overseers by reducing their ability to object to unreasonable judgments that, quote, comply with the framework. A related point, in effect the judgment framework would thus create in their view a safe harbor for judgments that comply in form with the framework regardless of the quality of the judgment. And thus it could undermine their third concern, thus it could undermine quality as practice seeks more to comply with the framework than on making the best judgment. Now my answer to these concerns - and these were heartfelt concerns by very serious folks, these were not dismissed lightly by CIFIIR - but at the end of the day, I believed that if we were proposing a process I would have these concerns on something where we were proposing something where you input data and out comes an answer. I could understand that form could drive substance here. But this doesn't tell you what to do. It doesn't tell you what the judgment ought to be. It simply says think hard about these 11 areas and in doing so you will be more persuasive, you will come up with a better, more reasoned judgment and that's what we had in mind.

ZOE-VONNA PALMROSE: Greg, you mentioned that as a complement to its recommendation for an SEC policy statement on accounting judgments that CIFIIR also recommended the PCAOB issue a policy statement on audit judgments in the context of PCAOB auditing standards. So maybe this is a good time, Bob to ask you, what's incremental here about judgment from an audit perspective that would support this kind of recommendation?

ROBERT J. KUEPPERS: I think it's important to just admit or declare here that it would be impossible for you to do an audit without an incredible number of judgments. While they may be a little different than the registrant or the client company's accounting

decisions, judgments made in the course of an audit are pretty fundamental, including and starting with the identification of risk, determining how to address those risks by designing your tests, what materiality is, what the scope timing and nature of audit tests and probably the ultimate judgment - the one that is sort of the bottom-line from an auditor's perspective - is when do you have sufficient competent evidential matter to report the opinion you ultimately issue. I think each and every one of these judgments is the key to the delivery of high quality audits and therefore goes right to the heart of investor protection. So I think given the good work of ClFIR it would be important to have a policy statement from the PCAOB. It could be a companion piece, a parallel piece, it might look a little different but I believe it would include the same kinds of what I called the disciplined approach to common sense that would signal to the firms doing this work the standard to which they would be held. And of course key to that, as with the accounting decisions by our clients, is the documentation piece that in the end pulls together why you did what you did and serves as the record for the future.

GREGORY J. JONAS: I am struck in thinking about the judgments of auditors versus the judgments of say preparers just how much they have in common, particularly in a post SarbOx world. I was hard pressed to think about things that auditors judge that the preparer doesn't have to judge. I was initially thinking about things like sample sizes and things that I kind of thought fell uniquely in the auditors' purview, but I think the preparer is saddled with all the same kind of stuff because they have to ensure that their books and records are accurate and so they need to be thinking like auditors as they design their internal controls and internal processes. So I really think we have a lot in common.

Now, that raises the question, Okay Greg, if you are right that the judgments are very similar between the preparer and the auditor, why does the PCAOB need to do anything then? Why not just at the SEC? My answer is, the PCAOB also is a regulator and an important influencer of practice in the auditing profession. It too should signal what it looks for in judgment quality particularly if they feel anyway that it's incremental to what the SEC might say. And so it's the transparency and the benefits that come from declaring yourself as to what you look for in a judgment, that are the benefits from that are as good from the PCAOB as they are in my view from the SEC and that's why ClFIR, I think, recommended that both should declare themselves. It be healthy for everybody in this judgment framework.

ROBERT J. KUEPPERS: And that's very well said, because the largest firms are inspected annually. If you have the play book on what to expect, it's more likely that you can comport with the expectations of the regulators that ultimately have to weigh in.

ZOE-VONNA PALMROSE: We have some questions from listeners and so maybe this is a good time to probe those a little. The first question asks us to explore professional judgment within public accounting firms and so let's talk about whether, for example, high quality professional judgment is identified within public accounting firms and if it is identified, what are the factors that represent high quality?

ROBERT J. KUEPPERS: I am struck by the question. I think the listener in this case has really hit on an important element because it's very easy for people to think, "Well, it's one thing for a company to prepare financial statements but when it comes to auditors the firms probably don't value these kinds of skills." And honestly nothing can be further from the truth. Auditors, as they progress in their career - ultimately if they stay with the firm - the kind of person you want to admit to the firm as partner is the kind

of person that has the capacity, the will and the strength to reach judgments, and to stand behind their work. And so the way we talk to our young people about it, and the way we train around applying professional judgments in the auditing world, have many of the elements that CIFIIR laid out. Although I don't think we really have 12, it boils down to the same common sense approach.

The toughest thing often in auditing is issue identification. Identifying the issue is step one. But once you do, then it's gathering the facts around it, reviewing all the relevant literature that bears on the nature and scope of your audit test in figuring out exactly what you are testing for, and a full analysis including getting an expert (those that understand the technical side of auditing) and consulting if it makes sense to do so. But at the end of the day - once you have got all those elements and pieces and you've discussed it fully and reached a decision to conclude and then, importantly documenting - to me it's the same approach applied to a different discipline. And when it comes to auditing the client's accounting judgments it's exactly the same framework. I am just saying when you think of it from audit standpoint it's a very parallel process. And it's one that we do value highly, and the people who are the most successful and have the most longevity in the firms are the ones that are able to master an appropriate way to reach judgments. We always say the judgments you want are the ones that stand the test of time.

GREGORY J. JONAS: I think back to my years in public accounting but Bob, I can't think of an evaluation form I either wrote or read that didn't address almost as a cornerstone issue what is the person's judgment quality. What I found curious is that actually, until I served on this CIFIIR committee, I really hadn't thought hard about what does that mean, "the person's got good judgment." What differentiates a good judgment versus a non-good judgment? I think this so-called judgment framework again, I don't think it's rocket science, common sense does come to mind but yet I think those 12 things are the attributes one means when one says, "This person has good judgment." It means they can make a choice, defend it and support it against not only the choice itself but against the reasonable alternatives. And that's what we meant all those years when we were writing about good judgment in these evaluations.

ROBERT J. KUEPPERS: And the way you would see that would be through the successive layers of review of an individual's work, the next person up the chain, the manager or the partner. The fact is those that were most successful were the folks that survived all those reviews and if challenged and asked they were able to explain exactly what they did and point you to the documentation that proves it.

GREGORY J. JONAS: That's probably why regulators would remind us all that that's the important role they serve is providing that oversight in that second guessing. It drives practice to do, to think it through more than perhaps otherwise would be the case. That's why I think regulators believe that they are very much in the public interest and I happen to agree with them.

ROBERT J. KUEPPERS: I just think on the second-guessing stuff, I am not sure we're in the same place.

GREGORY J. JONAS: Bob, you're second guessing my comment.

ROBERT J. KUEPPERS: There you go. I am sorry.

ZOE-VONNA PALMROSE: I wouldn't try to second guess either one of you. But before we move off of CIFIr, it's noteworthy that the CIFIr report came out more than a year ago and neither the Commission nor the PCAOB have formally acted on any of its recommendations yet, including the recommendation related to accounting and auditing judgments. I know our listeners would be very interested in each of your perspectives on the path forward here. Let's spend a few minutes exploring your thoughts on what will happen. For example, does it matter who acts first? Or is any action by the Commission and PCAOB even essential?

ROBERT J. KUEPPERS: Let me take that one first. I think it's interesting in terms of the passage of time you noted the fact that it's been a little over a year. I would like to believe that if the last year hadn't been so difficult on so many fronts maybe things would have been a little further along. But I think the reality is that we have had the recession, we have had economic crisis, we have had all the markets roiled and everything has taken so much of our time. Plus we have really a new administration in Washington, a new Chairman at the SEC, and just weeks ago Jim Kroeker was named Chief Accountant. So it's been one of those unusual periods of time. But we are where we are.

As we think about moving forward it's still my hope that the Commission in the foreseeable future would take up and consider whether such a framework should be put forward. I think it's one of the more important elements of CIFIr, and in speaking with certain of the Commissioners, there's encouragement that we shouldn't forget this good work, it shouldn't sit on the shelf and gather dust. We should pick it up and see what makes sense to deal with.

I do believe, however, that it's likely the SEC should act first. I think it would be unlikely that the PCAOB will get out ahead of the SEC on this. I think the idea would be, once the SEC finishes its work on this and gets a policy statement together - I don't know if they would go out for notice and comment, for example that would be a time when there's a good solid draft - at that point the PCAOB certainly could pick up the pencil and decide how their framework will align with it. I would think they would fit together pretty nicely. So my urging would be for the Commission to take it up first, and the PCAOB to be a sort of a fast follower in taking the lead from the Commission. Greg, does that square with what you were thinking?

GREGORY J. JONAS: It does. I think it's essential that the SEC and the PCAOB act because they are important aspects of driving practices we discussed earlier. Absent their action I don't think this is going to catch fire as it should. I do believe as Bob does that the first step should be the SEC takes action and followed shortly thereafter by PCAOB action. Interestingly I was at an advisory council meeting just last week at the PCAOB and the chief auditor reported, when discussing the PCAOB's agenda, that the board has decided that they will add a project on the judgment framework if the SEC takes any action related to the judgment framework. So they are waiting for the SEC to take action. By implication, absent SEC action, the PCAOB does not intend to act.

ROBERT J. KUEPPERS: That certainly is a strong signal that what we are just talking about is likely to be the direction. But I do wonder this, Greg - and even Zoe-Vonna if you have a thought - you said earlier in your remarks that the strongest element of this

would be a Commission policy statement and that would have so much more breadth of coverage across the SEC than an individual staff declaration or the equivalent of the Staff Accounting Bulletin. While this is all under consideration, though, would it be possible to implement this almost in administrative practice, short of a Commission policy statement?

GREGORY J. JONAS: You mean by one of the divisions?

ROBERT J. KUEPPERS: Yes, I guess what it would have to be either in Corp Fin or OCA [Office of the Chief Accountant]?

GREGORY J. JONAS: Zoe-Vonna, you were there. You know the place better than I do but my strong sense is that if one of the divisions had a strong objection - for example, let's say the Office of Chief Accountant decided that they would go forward with an administrative piece under their office and Enforcement jumped up and said, "No, we don't agree with the direction that this is going. We are afraid this is going to undermine some of our enforcement capability" - I can't see that OCA could ever issue such a document.

ROBERT J. KUEPPERS: At which point you are at the Commission anyway for the resolution.

GREGORY J. JONAS: There you go. That's how we got to a Commission policy statement, Zoe-Vonna

ZOE-VONNA PALMROSE: I would just have a slightly different perspective in that if you look at the components of the judgment framework, they are very consistent with the advice that OCA gives for consultations on accounting issues, OCA and Corp Fin. So that in all honesty behind the scenes here much of this is working away as part of just the natural framework for the consultation process. That doesn't diminish the advantage of a policy statement from the Commission, but I think it is noteworthy that this is consistent with the way that the staff does approach consultation.

GREGORY J. JONAS: I would also observe that Jim Kroeker, now the Chief Accountant, was very active in the CIFIr deliberations when he was deputy and Jim has said that he believes a judgment policy statement should be a high priority for the SEC. I doubt Jim would make that comment unless he thought he had support in the Commission to do it. I am optimistic but a little disappointed action hasn't taken place to date. Obviously these are unprecedented times with the credit crisis but I think that now is the time to hustle this forward and I really hope that the SEC takes quick action.

ZOE-VONNA PALMROSE: Just for our listeners so that they are not confused. What we refer to as CIFIr, "cipher," "siffer," all of those mean the same - the SEC's Advisory Committee on Improvements to Financial Reporting. We apologize that we can't converge on a pronunciation for an acronym but we do mean them all to be the same.

GREGORY J. JONAS: I would like to pile on with just one more point just speaking of the PCAOB. And that is, the Board has a project on its agenda now, standard setting project, to reconsider auditor communications with audit committees. One of the areas of communication will be of course sensitive judgments and estimates that that the auditor will talk to the audit committee about those management just made. Several of

us who were the advisory meeting observed that a judgment framework could certainly help an auditor communicate about... it's a neat framework for talking about how somebody arrived at a judgment and why you found it acceptable. So I think it could serve that purpose as well.

ROBERT J. KUEPPERS: It's an excellent point. I mean audit committees in particular - even though I understand it is not a process - but they would take some comfort for appreciating the deliberative elements that went into making that decision as they already see the financial reporting processes.

GREGORY J. JONAS: I would suspect more than a few audit committee chairs are going to expect that if they became knowledgeable the judgment framework, they would say, "All right, for this big deal not 200 but the handful of really sensitive important judgments each year in our company's financial statements. I would like it explained to me in common plain English in terms of the framework why the judgment makes sense." I could see audit committee members asking that even absent in SEC policy statement.

ROBERT J. KUEPPERS: Are you recommending that we have a separate judgment framework for audit committees that they have to follow?

GREGORY J. JONAS: Sounds like overkill to me.

ROBERT J. KUEPPERS: Okay. Good idea, run amok.

ZOE-VONNA PALMROSE: It sounds like it's time to change directions a little. In a recent speech Jim Kroeker, SEC Chief Accountant, reported that in the upcoming months the Commission will refocus on considering the use of International Financial Reporting Standards by U.S. companies. IFRS is considered a more principles-based approach to accounting standards as compared to U.S. GAAP which is often labeled as rules-based. Next week on October 28th, Part II of the Deloitte Fireside Chats will explore principles versus rules-based accounting and auditing standards. But to tee up that session perhaps we could spend our remaining time conversing on the implications of IFRS and the SEC's IFRS initiative for professional judgment and then even vice-versa, the implications of professional judgment for IFRS and the SEC's initiative. Bob, would you like to get us started?

ROBERT J. KUEPPERS: Absolutely, there's sort of an obvious nexus between the conversation in the first part of our program today and this question. There are some that might ask - and I would probably be either in this crowd or right on the fringe of it - the group that asks, "Is it possible that an IFRS world (that implies the United States is part of the IFRS world) could function effectively without more discipline or more consistency on how one approaches professional judgments?" In other words maybe I am speaking to the second part first but the point is that IFRS implementation in the United States I think would be difficult without some progress on this front. I think it would leave open too much in the way of confusion and expectations. I mean we can debate how principles-based versus rules-based IFRS standards are, but part of it is that it is relatively young in the lifecycle compared to U.S. GAAP, and they haven't really - they don't - cover every little thing and they certainly don't cover some industry areas. There's some holes in it, I guess you could say.

But it's pretty apparent that despite all the events of this year, the SEC understands the need to deal with the [IFRS] roadmap to take some next steps. In the bargain they are going to be signaling some kind of approach. My own bias is that it's likely that IFRS is inevitable in the United States, but I have no predictions as to when. There are a tremendous number of issues to be overcome before it's a reality but every one of them comes right back to this whole issue of judgment – that is true in the audit firms, it's true in the preparer community, and certainly it's true in the regulatory community. If you were to fast forward to some future date and we were having the same conversations we are having today but about financial statements prepared under IFRS, I think we would all be looking for some common ground to stand on to make sure that we could cycle through the reviews and all the things that need to get done to raise capital.

GREGORY J. JONAS: I will make first an editorial observation about cookbook rules versus principle based standards. Here's what's not controversial. I don't know of an accountant in the world who would disagree that accounting standards ought to be objectives oriented and principles based. Those two things are not controversial at all. The controversy starts where what beyond principles should guidance provide? And that's where there gets to be debate. Because some people believe that accounting standards ought to be principles only standards and others believe that there is a very appropriate place in an accounting standard for implementation guidance below the principle level, but something above cookbook rules that is necessary to get practice to a reasonable level of comparability. Because comparability among companies in similar economic circumstances is key to the investor analysis. Put me in the second camp, I am very much a believer that implementation guidance has a legitimate place in the accounting literature and I am not a principle only guy. But I certainly believe that all accounting guidance ought to be objectives oriented and principles based. For those of you who haven't read, the SEC did a study I believe in response to the Sarbanes Oxley Act on principle versus rule based standard and I thought it was just wonderfully written and very balanced, where they explain much more eloquently than I just did, this debate about how deep accounting standards ought to go.

So, the problem now that everybody also agrees on is the problem of detail rules is that they often draw arbitrary lines that distort economic reality and the poster child for this is leasing literature where we clearly have cookbook, we clearly have arbitrary lines and at least the major investment houses that I am aware of all routinely adjust financial statements to capitalize operating leases because they believe they have created property rights and commitment. So, I don't think detailed rules is the way to go either. So whether we are talking in some reasonable level of implementation guidance or principle only, I certainly agree with Bob, we are in the game of professional judgment inevitably and that's not bad, it's actually healthy.

So we need to promote professional judgment, we don't want to undermine it and that's really what this judgment framework is all about. What we have going in the last few years is a vicious circle downward and that is because people are so second guessed by multiple levels. The poor practitioner is second guessed by your internal audit function, their auditor, the PCAOB, the SEC Enforcement Division, plaintiff counsel, there is no end to the second guessing. That drives people to ask standards setters to create ever more detailed rules so that they can prove compliance and be beyond second guessing. This is a very counter productive environment. I actually participated in part of the demands for more detailed rules in my past, I am kind of sorry I did, but I was part of that problem and it's a vicious cycle that we have got to break. IFRS gives us the chance to

break the cycle. By jumping on IFRS we can get on to a lesser volume of detailed rules and at the same time if we have a judgment framework that can help build credibility for the judgments made, we can go from this vicious cycle to a virtuous cycle and get out of this hole. But right now we are in a hole and we are digging deeper every day.

ROBERT J. KUEPPERS: I am glad to see you have come around to my view that second guessing is a bad thing. It took almost an hour but I am very grateful.

GREGORY J. JONAS: Can I change my mind?

ROBERT J. KUEPPERS: Oh no, no, you can do anything you like. Of your points, one deserves a little bit of reiteration. There is a continuum here of the cookbook which envisions sort of Iron Chef type competition as to who can come up with the best accounting. But principles-only without any context I don't think are standards. I think you have to sort of flesh them out in terms of reality with some level of guidance, we just can't devolve in the hundreds of pages of FAQs or anything like that. And so there is some kind of middle of the road which is going to feel good - that we know enough about the essence of the principle that we can all deal with it.

ZOE-VONNA PALMROSE: Well, thank you Greg and Bob for this excellent conversation. And I should mention that this program will be a valuable addition to the virtual museum and archive's growing collection on accounting. On behalf of the SEC Historical Society I would like to thank Deloitte for its generous support and assistance in making this program possible. I also want to note that the audio of this program is now available on www.sechistorical.org and will be permanently preserved in the museum. In addition, an edited transcript will be available soon on the website.

I encourage our audience to listen in next Wednesday, October 28th at 1 PM Eastern time for Deloitte Fireside Chat Part II, which will explore what we have just been talking about here, principles versus rules-based accounting and auditing standards. Professor Patricia Fairfield of the McDonough School of Business at Georgetown University will be the moderator, and Bob Kueppers will be joined by Scott Taub, Managing Director at Financial Reporting Advisors and former Acting and Deputy Chief Accountant at the SEC in the Office of the Chief Accountant. Deloitte Fireside Chat Part II will also be free and accessible worldwide on www.sechistorical.org and you are encouraged to send in your questions to the website by October 27th. So please plan to join us on October 28th and thank you again for being with us today.