

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on February 22, 2007 that related to the Board's proposed auditing standard titled "An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements." The February 22, 2007 meeting also included a panel discussion on forensic audit procedures that was not related to the proposed auditing standard. That discussion is not included in the transcript.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

STANDING ADVISORY GROUP

Thursday, February 22, 2007

8:30 a.m.

The Army and Navy Club

901 17th Street, N.W.

Washington, DC

	<p style="text-align: right;">Page 8</p> <p>1</p> <p>2 MS. VIRAG: We presented the topics of</p> <p>3 audit control over financial reporting to the SAG on</p> <p>4 several previous occasions, most recently June of</p> <p>5 2006.</p> <p>6 As you know, this was shortly after the</p> <p>7 board announced that it would be undertaking rule</p> <p>8 making to change Auditing Standard Number 2 and we</p> <p>9 had the opportunity to discuss with the SAG several</p> <p>10 major areas of potential change.</p> <p>11 The input that we received from the SAG in</p> <p>12 June was an important and helpful part of the</p> <p>13 development process of that proposal.</p> <p>14 We are very pleased to have the</p> <p>15 opportunity to obtain further input from the SAG on</p> <p>16 these proposals to consider along with the rest of</p> <p>17 the public comments that we receive. Just to remind</p> <p>18 everyone, the comment period on these proposals ends</p> <p>19 next Monday, February 26.</p> <p>20 The topics we have selected for today's</p> <p>21 discussion are among those that have been raised in</p> <p>22 comments we received so far. We are presenting these</p>
	<p style="text-align: right;">Page 9</p> <p>1 issues here today to promote additional discussion</p> <p>2 and provide as much input as possible for the board's</p> <p>3 deliberation.</p> <p>4 The topics we have singled out for</p> <p>5 discussion include whether the proposed standard</p> <p>6 allows for the appropriate use of auditor judgment</p> <p>7 while sufficiently safeguarding the quality of the</p> <p>8 audit, whether the proposal adequately emphasizes the</p> <p>9 importance of company level controls and the effect</p> <p>10 they may have on the auditor's testing, whether the</p> <p>11 direction in the standard on scaling the audit</p> <p>12 sufficiently addresses differences in company's size</p> <p>13 and complexity, whether differences between the</p> <p>14 process management would follow to perform its</p> <p>15 evaluation of internal control under the Securities</p> <p>16 and Exchange Commission's recently proposed guidance,</p> <p>17 and the process the auditor would follow to complete</p> <p>18 his or her audit under the board's proposed standard</p> <p>19 would result in any implementation issues. And if</p> <p>20 so, how those issues might be addressed or managed.</p> <p>21 Finally, whether the proposed audits</p> <p>22 standard on considering and using the work of others</p>

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<p>1 would meet the objective of removing unnecessary</p> <p>2 barriers to using the words of others and to promote</p> <p>3 better integration of the audits.</p> <p>4 Additionally, we plan to have time left at</p> <p>5 the end of the discussion for SAG members to bring up</p> <p>6 any other topics related to the proposals that they</p> <p>7 believe need to be addressed.</p> <p>8 In order to keep time for that, we plan to</p> <p>9 move through the questions by devoting 30 to 40</p> <p>10 minutes to each topic. With that, I'd like to open</p> <p>11 the discussion with our first topic, auditor</p> <p>12 judgment.</p> <p>13 We have two questions on the topic and</p> <p>14 you're welcome to discuss either or both at this</p> <p>15 time.</p> <p>16 Cynthia Cooper?</p> <p>17 MS. COOPER: I think that the new standard</p> <p>18 is definitely going to be less prescriptive and</p> <p>19 allows for more auditor judgment, which is good.</p> <p>20 Hopefully, we'll start to see more</p> <p>21 reliance by the external auditors on others. It will</p> <p>22 be interesting to see how that plays out. As far as</p>	<p>1 both groups have crafted reasonable standards.</p> <p>2 Nonetheless, I have reasonable concerns with the</p> <p>3 exposure drafts. AS-5 is less detailed, some would</p> <p>4 say more principled, than was AS-2. And since</p> <p>5 principles-based guidance is currently in favor, this</p> <p>6 must be good.</p> <p>7 But critically, for a principles-based</p> <p>8 regime to work, there must be vigilant and effective</p> <p>9 enforcement. Is this true? The PCAOB has adopted an</p> <p>10 inspection model, not an enforcement model. That</p> <p>11 basically leaves it to the SEC. The SEC enforcement</p> <p>12 budget has been squeezed in recent years. What is</p> <p>13 the back stop? The back stop is private securities</p> <p>14 litigation.</p> <p>15 But accounting firms are seeking liability</p> <p>16 relief with some support, it seems, from the SEC.</p> <p>17 And even the SEC has recently filed a friend of the</p> <p>18 court brief with the U.S. Supreme Court that would</p> <p>19 make it harder for investor lawsuits to succeed.</p> <p>20 My overall conclusion is the PCAOB and</p> <p>21 PCAOB's efforts would likely reduce costs without</p> <p>22 hurting good actors, but at the cost of reducing</p>
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<p>1 the quality of audits, I think that really will come</p> <p>2 back to the competence, to the objectivity, to the</p> <p>3 independence of the individual audit team.</p> <p>4 And I also think that the inspection</p> <p>5 reports are going to play a key role in setting the</p> <p>6 tone. While the inspection reports I think are an</p> <p>7 excellent way to give feedback to the firms, I think</p> <p>8 it is critically important that the inspection</p> <p>9 process be in sync with the tone that we want the</p> <p>10 standard to set, because if the auditors use judgment</p> <p>11 and these inspectors come back and second-guess that</p> <p>12 judgment, for example, obviously it is going to</p> <p>13 impact the audit going forward. In some cases, maybe</p> <p>14 that's necessary but we need to make sure they're</p> <p>15 both in sync.</p> <p>16 MS. VIRAG: Joe Carcello.</p> <p>17 MR. CARCELLO: I applaud the SEC and PCAOB</p> <p>18 for their work. In an environment characterized by</p> <p>19 intense lobbying by well-funded and well-organized</p> <p>20 groups that often were more concerned with their</p> <p>21 narrow self-interest than with the public good.</p> <p>22 Given this political cauldron, I think</p>	<p>1 effectiveness for bad actors. Is this socially</p> <p>2 optimal? Is this in the best interest of investors?</p> <p>3 These are the questions that I think the</p> <p>4 board should be asking itself.</p> <p>5 MS. VIRAG: Bob Kueppers?</p> <p>6 MR. KUEPPERS: Thank you, Sharon.</p> <p>7 Two things to the questions on the table</p> <p>8 right now. I agree that the changes in the standard</p> <p>9 do provide for the appropriate level of auditor</p> <p>10 judgment. What we had before AS-2, as Cynthia said,</p> <p>11 was a prescriptive standard, but guidance suggesting</p> <p>12 that overlaying that is all kinds of opportunity for</p> <p>13 judgment. I think this standard finally brings into</p> <p>14 line that notion and the construction of the standard</p> <p>15 itself. I think it will give us the appropriate</p> <p>16 flexibility. I welcome and I think my partners will</p> <p>17 take the spirit of that in implementing the standard</p> <p>18 which I think will be good on the cost side.</p> <p>19 The second question about safeguarding the</p> <p>20 quality of the audit, I think the fundamental</p> <p>21 safeguard built into the standard is the fact the</p> <p>22 standard applies equally to all entities. In other</p>

<p style="text-align: right;">Page 14</p> <p>1 words, it is a single standard for all, scaleable 2 based on size and complexity. I think size is an 3 interesting metric, but I think complexity is much 4 more the driver of how much work is appropriate in a 5 given set of facts and circumstances. 6 I think the standard has a single model as 7 opposed to a multiple model or other construction 8 that should serve if scaleability is -- I'm sure 9 we'll talk about scaleability. If that's 10 appropriately dealt with, audit quality will be 11 preserved and overall I think the exposure draft is 12 an excellent move in the right direction. 13 MS. VIRAG: Jeff Steinhoff. 14 MR. STEINHOFF: I'd like to reinforce a 15 couple of comments already made. I do support 16 strongly the move toward risk-based. I think it is a 17 big improvement over standard 2. This, though, on 18 its own -- I think Cynthia was getting to it -- does 19 not assure quality. It will be very important that 20 the PCAOB and SEC reinforce what the overarching goal 21 is and that is to protect the investor and to assure 22 there is a quality audit.</p>	<p style="text-align: right;">Page 16</p> <p>1 I do share Cynthia's opening comment 2 relative to the concerns that tie with the 3 inspections to ensure that that risk base is 4 interpreted in an appropriate way. And really I 5 think you can do that by looking at how risk base is 6 applied and look at the process that the audit firms 7 are doing to try to get their judgments without 8 necessarily questioning the judgment underneath. 9 So I would -- you will have to say there 10 may be appropriate judgments announced in some of the 11 early inspections that had to be dealt with, but a 12 focus on the process will be important as you go 13 forward. 14 MS. VIRAG: Gaylen Hansen. 15 MR. HANSEN: I would also like to add my 16 thank you for all the hard work. I'm sure this was 17 very difficult to do, and we've had a lot of 18 discussions about that. I think there's some changes 19 that really will help us, in particular, some of the 20 definitional changes of significant deficiencies, 21 material weaknesses, clarifying the objective of what 22 we're actually trying to accomplish here. I think</p>
<p style="text-align: right;">Page 15</p> <p>1 I think it is very important -- the point 2 Cynthia was making -- that there be a direct tie 3 between the standard, how the inspections are done, 4 and the messages that are being conveyed. The point 5 that was made about good and bad actors, those that 6 want to do the job will see this as an opportunity to 7 do it in a efficient and effective way. And those 8 who perhaps never wanted to do it will see this as a 9 way out. 10 So you want to assure that people don't 11 see it as a way out. They see it as a more efficient 12 and effective way to do the job better. 13 MS. VIRAG: Kimberly Gavaletz. 14 MS. GVALETZ: I want to applaud the 15 efforts of the PCAOB. I think they listened to a lot 16 of things people around this table have brought 17 forward in a thoughtful way. I do agree with the 18 less prescriptive nature of the standard as written. 19 I believe it sets the appropriate level. It says in 20 a way it had to be done relative to risk-based. That 21 in itself will have to be evidence that the 22 inspectors will be able to look at.</p>	<p style="text-align: right;">Page 17</p> <p>1 going to some of the language in standard number 5 on 2 probability measures was really helpful from my 3 viewpoint. 4 With that said, I think there's still room 5 for improvement. I think on the -- all of the 6 language about the small business scaling and 7 complexities is great. How to apply this judgment, 8 the latitude we get and our clients get is really the 9 real issue. 10 I recognize that really defining what that 11 judgment means in this kind of standard is extremely 12 difficult, probably can't be done unless you are 13 approaching it from a principles-based standpoint. 14 And I wonder whether or not anyone has given some 15 thought to something along the lines of a prudent man 16 approach to this, a reasonableness standard that you 17 see in some of the legal definitions. 18 By that, what I mean is I am very hesitant 19 to approach a client and say, well, you need to add 20 people to your staff just so that you can provide 21 separation of duties. To me that wouldn't 22 be prudent. I probably wouldn't do it.</p>

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<p>1 So I think we need some examples of what</p> <p>2 clearly would be a material weakness, some instances</p> <p>3 of what wouldn't be. And then the difficult part of</p> <p>4 this is what falls down in between.</p> <p>5 And I do have an example that I would like</p> <p>6 to share this morning. We have a client in the Rocky</p> <p>7 Mountains, a SPAC -- a special purpose acquisition</p> <p>8 company -- subject to AS rules this year because it</p> <p>9 has in excess of 150 million in cap. And that 150</p> <p>10 million in cap is cash. Has two employees. A few</p> <p>11 equity transactions. All of its expenses are</p> <p>12 professional fees and salaries.</p> <p>13 Where does this fall out as far as</p> <p>14 segregation of duties and does it have a material</p> <p>15 weakness when the CFO is basically doing everything?</p> <p>16 And the only judgment the CFO has to make is whether</p> <p>17 or not the small amount of goodwill on the books</p> <p>18 needs to be impaired.</p> <p>19 So that's an example of the things that we</p> <p>20 are dealing with in our office. And I think that</p> <p>21 maybe this prudent man definition would help some of</p> <p>22 the small filers, some of the small firms deal with</p>	<p>1 the fundamental differences going forward in how we</p> <p>2 define risk-based approach from a past -- from a</p> <p>3 top-down risk-based approach? Is it different? Are</p> <p>4 we doing the same things?</p> <p>5 It seems that even your most recent</p> <p>6 inspection report would indicate that at least in</p> <p>7 these anecdotal cases, the assessment of risk was not</p> <p>8 making the auditor focus their attention in the</p> <p>9 correct places. They missed it. Didn't pay</p> <p>10 attention. First, is it okay to get that concept on</p> <p>11 the table under this point? Is that question fair?</p> <p>12 MR. RAY: I'm sorry, Ted.</p> <p>13 Specifically what question would you like</p> <p>14 to throw on the table at this point?</p> <p>15 MR. TED WHITE: First, I'd like a basic</p> <p>16 explanation of the risk-based methodology that we</p> <p>17 would use to be making the judgment calls here. It</p> <p>18 seems to me -- first, tell me if I'm wrong in that</p> <p>19 that would really be the underpinnings of whether the</p> <p>20 appropriate level of judgment is applied in this</p> <p>21 standard? So if the judgments are going to be based</p> <p>22 upon a risk-based approach, is the risk-based</p>
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<p>1 the forthcoming AS-5.</p> <p>2 MS. VIRAG: Ted White.</p> <p>3 MR. TED WHITE: Thank you. It seems to me</p> <p>4 to be inevitable that some level of judgment is going</p> <p>5 to be maintained here. And I generally support that</p> <p>6 concept. But it also appears that the question on</p> <p>7 the table is maybe missing the larger issue which is</p> <p>8 the risk-based approach from which those judgments</p> <p>9 are based upon.</p> <p>10 First, let me say, I think the concept is</p> <p>11 solid, and I very much like the philosophy of a</p> <p>12 risk-based approach. It seems in a resource</p> <p>13 constrained world, investors can benefit from a truly</p> <p>14 rigorous risk-based approach that is functional and</p> <p>15 accurate and gets auditors to focus the resources in</p> <p>16 the right places.</p> <p>17 I have a simple question about the</p> <p>18 definition of risk-based and what it actually means</p> <p>19 going forward, and is it different than what people</p> <p>20 have, this sort of negative perception of whether</p> <p>21 risk-based worked in the past.</p> <p>22 First, I'd like to understand, what are</p>	<p>1 approach appropriate to set those judgments?</p> <p>2 Whether or not there's judgments or not,</p> <p>3 seems to me to be -- that's a foregone conclusion.</p> <p>4 Auditors have to make judgments. There's no --</p> <p>5 unless you have no resource constraints where they</p> <p>6 recreate everything -- and that's ridiculous, they</p> <p>7 have to make judgments. I'm willing to just accept</p> <p>8 that.</p> <p>9 But it is the process that drives them to</p> <p>10 make those judgments and where they're going to apply</p> <p>11 the resources that seems to me to be more important.</p> <p>12 MR. RAY: Well, I'll go ahead and add a</p> <p>13 commentary here. My colleagues perhaps would like to</p> <p>14 add some color to it as well and then throw it back</p> <p>15 to the floor.</p> <p>16 But basically my view on the risk-based</p> <p>17 approach is that the concept of risk is an important</p> <p>18 aspect of many of the points through the process of</p> <p>19 conducting the audit of internal control. In order</p> <p>20 to evaluate the risk, the auditor doesn't just</p> <p>21 evaluate in a vacuum. The auditor must go out and</p> <p>22 obtain knowledge and evidence related to the various</p>

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<p>1 risks that the auditor needs to assess, then perform 2 a judgment about those risks.</p> <p>3 So there is a due diligence or a due care 4 standard I think that would be applied around the 5 auditor's procedures, around the -- what the auditor 6 does to obtain the information necessary to assess 7 the risk and then support the judgments that the 8 auditor needs to make.</p> <p>9 MR. TED WHITE: Uh-huh. That's not 10 exactly the question. Does that work? Has that 11 worked? Isn't that the fundamental underpinnings of 12 this question, this position?</p> <p>13 MR. RAY: The standard itself does try to 14 provide direction around what the auditor should be 15 doing to satisfy that -- those requirements, that 16 standard, and the objectives. With regard to your 17 question, I think I would turn to the various members 18 of the group here to comment.</p> <p>19 MS. VIRAG: Craig Omtvedt, do you want to 20 comment?</p> <p>21 MR. OMTVEDT: Just to set the stage a 22 little bit, I would say to you that I think the</p>	<p>1 attention. I think things that should be looked at 2 would be things like sell side analysts reports, 3 looking at peer companies, making sure the firm and 4 engagement partner really understand the dynamics of 5 the industry within which the company is operating.</p> <p>6 I think there's things such as looking at 7 company's margins. Do they make sense in the context 8 of the overall industry?</p> <p>9 You know, there's evidence in the past -- 10 and I'm not going to get into particular frauds -- 11 but with all the competition, we're saying there's no 12 way in hell those margins can be right.</p> <p>13 You ask yourself: Why aren't the auditors 14 focused on those kinds of things?</p> <p>15 So I think as we think about not just this 16 risk-based assessment makes sense, we need to come 17 back to what's the guidance and what's the standards, 18 what are the factors that need to be considered in 19 performing that assessment, and it needs to go beyond 20 just the company itself.</p> <p>21 MS. VIRAG: John Morrissey? 22 MR. MORRISSEY: I guess I'll jump around</p>
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<p>1 guidance that's come out from the SEC to give 2 management perspective on how to approach its 3 fulfillment of its control responsibilities, I think, 4 is a very positive thing.</p> <p>5 I think the changes that you're proposing 6 here with AS-5 to go to a more risk-based approach is 7 fundamental and aligned with basic concepts of 8 assuring we get appropriate return on investment for 9 the activities that take place.</p> <p>10 The return on investment here, obviously, 11 is greater investor confidence in the financials that 12 are being put out.</p> <p>13 But to play off Ted's point a little bit, 14 I think there are modifications that we need to be 15 considering and perhaps institutionalize in terms of 16 how the auditors perform their risk assessment.</p> <p>17 And I would suggest to you that it should 18 be more than simply operating within the company to 19 get a sense of what's the tone at the top, what's the 20 quality of the control process put in place.</p> <p>21 I think there's external diagnostics that 22 candidly I don't think are being given enough</p>	<p>1 and go back to the questions initially on the table. 2 I think it's important just to remind even myself 3 that I was not a big fan of opening up AS-2 to begin 4 with. I thought it was a good standard, rigorous 5 standard.</p> <p>6 It was intended to be such. And I guess I 7 was a little concerned when I lost that debate that 8 AS-2 was going to be opened up. Having said that, 9 also, the concern is, is there enough opportunity for 10 professional judgment in the proposed standard? My 11 view is that AS-2 was fraught with opportunities to 12 exercise professional judgment. The words I think 13 were there. For whatever reasons, people weren't 14 reading the words and weren't following what the 15 words allowed people to do.</p> <p>16 You look at the notion of risk-based audit 17 as being the new way to do auditing. That's nothing 18 new. It was available to preparers under AS-2. A 19 lot of companies weren't using a risk-based approach. 20 That's really not anything that's terribly 21 revolutionary.</p> <p>22 Risk-based audit proposals, unfortunately,</p>

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<p>1 were in vogue back in the late '80s and weren't 2 executed very well. That's a concern people have to 3 this day that it is used as an excuse to cut back on 4 work and not focus in on the quality of what you are 5 trying to do. And risk-based approaches sometimes 6 are done by lower level staff people that aren't in a 7 position to have that in-depth knowledge of the 8 business and industry in order to properly assess 9 those risks.</p> <p>10 If properly executed at the right levels, 11 it could be very, very effective.</p> <p>12 To the last point, is the proposed 13 standard sufficiently rigorous to safeguard the 14 quality of an audit. I think the new proposed 15 standard neither diminishes nor enhances that notion. 16 It will still be left up to the people executing and 17 the auditor to look over the shoulder of the 18 preparers and make sure the standards are properly 19 followed.</p> <p>20 So to answer the question, I guess I'm 21 sort of neutral on the second one.</p> <p>22 MS. VIRAG: Ted, we had more input. I</p>	<p>1 Or is there any difference? Is this 2 approach new or is it the same?</p> <p>3 MS. VIRAG: Sam, do you want to comment?</p> <p>4 MR. RANZILLA: I didn't think I was next 5 line. Let me try to address Ted's questions. I'll 6 play a little bit off John's comments. Risk-based is 7 nothing new, and maybe to try to put it in some 8 context. Assume that you accept that the 9 implementation of AS-2 was bottom up instead of 10 top-down. We have instances obviously of that 11 happening.</p> <p>12 That was risk-based. I know there's 13 horrific stories about petty cash and things like 14 that. But the approach if you accept that AS-2 was 15 primarily implemented on a bottom up approach, that 16 was a risk-based bottom up approach.</p> <p>17 The difference between AS -- a bottom up 18 and a top down is, I mean, sort of obvious. You 19 attempt to come from the top down, and identify 20 controls where you can, say, that covers my risk as 21 opposed to testing a bunch of controls down at the 22 bottom level.</p>
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<p>1 wanted to check back in with you. Did you want to 2 continue your remarks?</p> <p>3 MR. TED WHITE: Maybe I didn't do a good 4 job asking the question.</p> <p>5 I guess what I'm saying is, isn't the risk 6 in what we're talking about here a risk-based 7 approach? It seems to me that while it is an 8 attractive concept, there is evidence coming from 9 your latest inspection report that it doesn't work 10 right or hasn't worked right. First, is that comment 11 accepted? And what is different about the process 12 going forward? How do we fix that? My personal 13 opinion is that investors are accepting of a 14 risk-based approach and can see this is a way to 15 locate resources to where they're most useful.</p> <p>16 But any time you have a process that has a 17 lot of judgment calls, then each step along the way, 18 you're relying upon thousands upon thousands of 19 individuals in firms to make these judgment calls.</p> <p>20 Is the inspection process different such 21 that we can support that? Is there enough in the 22 standard that drives that differently?</p>	<p>1 But there's nothing new about risk-based 2 approach. To John's comments, I think there is some 3 concern because there was late in the '80s or some 4 period of time some approach done that way that 5 probably wasn't implemented very well.</p> <p>6 But risk-based is -- I mean, one, you 7 can't do an audit unless it is a risk-based audit. 8 There's simply not enough time in the day to do that. 9 But the risk-based is now just the focus, the focus 10 of coming down versus coming back up.</p> <p>11 MR. TAROLA: I just wanted to comment on 12 this part as well. I think the proposed standard is 13 directionally sound. Where I think it does need 14 guidance is in assessing risk and how one should 15 assess risk from an auditing and financial reporting 16 perspective.</p> <p>17 And in my view, it's more of an enterprise 18 risk assessment than a failure of the accounts being 19 correct. Understanding the investor expectation, 20 understanding concerns of rating agencies, 21 understanding the strategy of the company, 22 understanding the governance structure, understanding</p>

<p style="text-align: right;">Page 30</p> <p>1 how the finance organization works and its 2 effectiveness and competencies and the qualitative 3 factors affecting risk, I think could be built out 4 more in the proposed standard and serve as some 5 guidance to auditors in making the risk assessments. 6 And then in turn making the judgments as to how and 7 to what extent they might be performing auditing 8 procedures. 9 But to Craig's point, I think that the 10 external implications to risk are important. And 11 from an insider's point of view, an officer certifies 12 financial statements, I look at our risk more from an 13 enterprise perspective than purely from a financial 14 accuracy perspective. I think you could build that 15 out. 16 MS. VIRAG: Jeff Steinhoff? 17 MR. STEINHOFF: Going to Ted's point, 18 risk-based approaches are not rocket science. I 19 think Sam was saying that. 20 I think people know how to do it well. It 21 shouldn't be difficult to do it well. When this 22 group discussed this at the time that AS-2 was being</p>	<p style="text-align: right;">Page 32</p> <p>1 We at the Government Accountability Office 2 have been applying a risk-based approach in our 3 audits from the beginning and we are strongly 4 supportive of the way the PCAOB is going here on this 5 and we were really pushing for that at the time of 6 AS-2. 7 But it is really up to people to learn 8 from some of the experiences of the past where this 9 was at times used as sort of a proxy for reducing 10 audit scope. We'll kind of fly through and we trust 11 top management and everybody is good on top here and 12 they're nice people; so we don't have to do a whole 13 lot of work here. 14 And that I think won't work real well 15 and -- but if we do apply it, in a rigorous manner, I 16 think it will, in fact, provide the same level of 17 assurance and provide for a much more effective audit 18 because you'll be focusing on the more important 19 things. 20 MS. VIRAG: Thank you, Jeff. 21 Ed Trott. 22 MR. TROTT: I think AS-2 was an</p>
<p style="text-align: right;">Page 31</p> <p>1 contemplated, there were a number of examples cited 2 where risk-based approaches didn't work well. 3 And I viewed all those examples as an 4 execution problem. Not a problem with the 5 fundamental nature of it. 6 I agree fully with John's comments which I 7 think should be memorialized somewhere because he hit 8 the nail right on the head. I think there was always 9 an ability to apply risk-based approach even under 10 AS-2. I can understand, however, the reluctance of 11 practitioners to do so, given the very prescriptive 12 nature of the standard and the fact that they were 13 being inspected against that standard. 14 And the fact that there had been a lot of 15 problems in recent years. 16 I think the real key is that a risk-based 17 approach does require hard work. It does require 18 very knowledgeable people to make the proper 19 judgments up front. There's skill required. Rigor 20 is required. 21 And I think it is just very, very key that 22 the profession, we all get it right.</p>	<p style="text-align: right;">Page 33</p> <p>1 implementation issue. My biggest concern is, are you 2 appropriately trying to get the right message out? 3 I would say that many people I expect look 4 at AS-5 as a relaxation of the goals and the needed 5 effort. I know that is not your objective, but I 6 think the problem is that in issuing AS-2, you've not 7 have done it that way. If I was going to do 8 anything, I would have amended AS-2 not to make this 9 look like, well, we learned our lesson, we're going 10 to significantly back off of the need to be diligent. 11 And I think that's the message that many 12 people have gotten from your actions. 13 I hope that you can work with the firms, 14 work with the SEC, work with FEI, work with other 15 organizations to emphasize AS-5 is not a back off of 16 the objective, AS-5 was to try to incorporate the 17 so-called efficiencies that should be learned in 18 implementation. 19 Unfortunately, I think your actions are 20 likely to be misinterpreted and deemed to be a 21 back-off of the objective that you, one, set with 22 AS-2 and that you're trying to articulate in AS-5.</p>

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<p>1 But that's going to be a hard message to get through 2 to those persons who, quote, are doing this basically 3 from the 50,000-foot level and that influences 4 behavior and everything else.</p> <p>5 MS. VIRAG: Arnie Hanish?</p> <p>6 MR. HANSEN: Let me try to touch on a few 7 topics. First of all, let me say I believe that 8 AS-2 -- I'm sorry, AS-5 is a giant leap forward in 9 trying to deal with some of the issues that had been 10 discussed and addressed over the last several years. 11 I think that it does -- as I think John 12 was saying -- I believe that it was an implementation 13 issue. I believe that the opportunity for the 14 auditor to extend the use of appropriate judgment was 15 there, but that it was an issue at the individual 16 local practice level where it wasn't consistently 17 applied.</p> <p>18 I believe that -- maybe using an example 19 of a risk-based approach and judgment, one of the 20 examples that I like to use internally all the time 21 is in the payroll area. Very seldom do you -- at 22 least we don't find in ours, as well as large</p>	<p>1 about the transactional activity as to whether or not 2 we pay 20,000 people appropriately on a semi-monthly 3 basis.</p> <p>4 I think that to me is where the 5 judgment -- auditor judgment needs to come in and be 6 applied in this new standard. It is truly looking at 7 where are the risks of a material financial 8 misstatement. I believe it affords us this 9 opportunity to have the appropriate dialogue.</p> <p>10 MS. VIRAG: Joe Carcello?</p> <p>11 MR. CARCELLO: I want to maybe second what 12 Ed said and directly get at your second question 13 there.</p> <p>14 An overarching concern I have is what I 15 view as the overemphasis on efficiency. Some people 16 ask me where I'm getting that from. Let me be 17 specific. If you look at page 3, first full 18 paragraph, second sentence, now I quote, the board 19 agrees that auditors should perform internal control 20 audits as efficiently as possible for companies that 21 are required by the SEC's rules to obtain an audit 22 report on internal control.</p>
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<p>1 organizations, a fraud being perpetrated or a 2 material risk that there was a financial misstatement 3 in a payroll area.</p> <p>4 But I believe that in at least the way it 5 had been previously interpreted, since that was a 6 significant level, a material level of cost and 7 expenses embedded in our financial statements as well 8 as the costs of our products, the auditors felt 9 obliged to spend a significant amount of time testing 10 payroll, as an example. The flows of payroll.</p> <p>11 But the risk that that was ever going to 12 produce a material misstatement was extremely low.</p> <p>13 I believe this new standard, at least in 14 the dialogue I've had thus far with our auditors, we 15 can try to get out of the trenches and get up to 16 higher levels and focus on the areas where embedded 17 within, for example, the cost of our products, 18 focusing in on the existence of inventory or how the 19 costs are developed of those products that we can 20 spend more time from an auditing standpoint focused 21 where is the real material risk that a financial 22 statement failure would occur, as opposed to worrying</p>	<p>1 And then if you go to the SEC's exposure 2 draft, they are advocating increased reliance on 3 management judgment. That may work well where 4 management is competent and honest. In situations 5 where management lacks integrity, i.e., fraud 6 situations, increased reliance on management's 7 judgment is going to result in management's opinion 8 being totally worthless.</p> <p>9 It seems to suggest the need for greater 10 auditor assurance, but the focus on AS-5 is on 11 increasing efficiency, not necessarily effectiveness. 12 In my view, the role of a regulator historically is 13 to prescribe a certain level of performance, 14 effectiveness, that must be met by the regulated 15 entity. Concerns with efficiency are best met via 16 market tests. If Ernst & Young spends too much time 17 performing the audit, fire them. Hire another firm.</p> <p>18 Focusing on efficiency -- 19 (laughter.) 20 -- or any of the other firms.</p> <p>21 Focusing on efficiency, especially by a 22 regulator, can easily lead to insufficient audit work</p>

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<p>1 and a decline in audit quality which is your second 2 question.</p> <p>3 MS. VIRAG: Bob Kueppers.</p> <p>4 MR. KUEPPERS: A couple points. We all 5 want to make sure Ted is satisfied with his good 6 question about risk-based. Let me point out that the 7 judgment areas don't -- aren't limited to the initial 8 assessment of risk.</p> <p>9 And I say initial, because let's assume 10 you're doing a first audit and you go through your 11 process to try to concentrate your testing in areas 12 of greatest risk. As you go about the work, you will 13 find your initial assessment needs to be adjusted and 14 updated. Some of the areas you viewed as risky might 15 turn out to be otherwise and some other categories 16 you had in a low category might contain more risk as 17 you learn more and perform related testing.</p> <p>18 The judgment cascades throughout the 19 entire standard including the decisions on the 20 nature, time, and extent of procedures that flow from 21 that initial risk assessment.</p> <p>22 And I think that one of the things you</p>	<p>1 When you introduce efficiency as a requirement, that 2 may work most of the time, but we all have situations 3 that are frankly difficult. And you may not get 4 their efficiently, but you may get to the end of the 5 journey as is needed.</p> <p>6 If in fact this doesn't protect investors, 7 then we wouldn't support the standard. And I think 8 that all that said, the reason we're supporting the 9 standard as an improvement is we think it will be 10 easier for our partners to implement with the 11 appropriate guidance from the firms. And I think it 12 does preserve the investor protection requirements in 13 the Act.</p> <p>14 MS. VIRAG: Randy Fletchall?</p> <p>15 MR. FLETCHALL: First, Joe likes to do a 16 lot of research. In research, you come up with 17 hypotheticals. I'm sure what he was giving was a 18 hypothetical about a particular audit firm doing too 19 much work and the market would react.</p> <p>20 This goes back to Ted's question, but to 21 what Bob said, and Craig said about the need to 22 understand the business and industry in which an</p>
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<p>1 might speculate about is if you don't use a 2 risk-based approach, what's the alternative? The 3 alternative would to be somehow test across the span 4 of the population, if you will, at the same level.</p> <p>5 And I think over time, the profession, the GAO, 6 others have used a risk-based approach appropriately 7 to focus the testing where the greatest risk lies.</p> <p>8 But that is a -- that's an analysis that needs to be 9 updated as you go through the course of an audit as 10 you learn more.</p> <p>11 Second point I have is as to the 12 sufficiency point, I don't think, at least from my 13 firm's standpoint, and I think probably the other 14 major firms as well, that we're getting the wrong 15 message. I think that the thing that troubles me 16 about the efficiency point and wouldn't bother me to 17 see it in adopting release language and things like 18 that, I don't think it is a good idea to have it 19 embedded in a standard.</p> <p>20 I think standards generally should -- 21 historically and in the future -- should represent a 22 minimum level of work that needs to be achieved.</p>	<p>1 audit client is operating. That is clearly important 2 to a risk assessment.</p> <p>3 What you have to be careful about is 4 thinking that is in lieu of actually understanding 5 how the financial statements get prepared and where 6 there might be errors or material errors. So that's 7 kind of incremental. I just don't think we should 8 get into the thought that if I understand the 9 business, I understand the industry, to Craig's 10 point, I don't see anomalies, therefore I conclude 11 everybody is right.</p> <p>12 Clearly if you see anomalies, that 13 requires work to determine if you have a problem. As 14 we talked -- Sam mentioned, look how we do 15 methodologies over the years. If we got into 16 problems back in, say, the late '80s or '90s, it was 17 trying to take too much of the fundamental out and 18 focus on if I know the business, I know the industry, 19 the company looks healthy, maybe I've done an audit. 20 That's not necessarily the case. That's where we had 21 problems. Yes, it is important. It is essential in 22 an audit to understand the business of the company</p>

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<p>1 and where it operates within its industry, but you 2 can't infer from that that therefore the financial 3 statements are correct and I don't have to do other 4 work.</p> <p>5 MS. VIRAG: John Kellas?</p> <p>6 MR. KELLAS: First of all, I want to say 7 without commenting on the details, the general 8 direction towards a slightly more principled, 9 slightly higher level standard seems to me to be 10 absolutely right. I think my general approach would 11 be to start at as high a level as is consistent with 12 improving and creating good practice and necessarily 13 make the standard more detailed if inspections, for 14 example, indicate that that is necessary.</p> <p>15 There was a comment about judgment and the 16 need not to second-guess the judgment of the auditor. 17 I think that there's obviously truth in that. It is 18 true, judgment should be allowed to flourish. At the 19 same time, I know regulators elsewhere are concerned 20 that judgment is used almost as a trump card.</p> <p>21 One point we are keen to make is auditor 22 judgment is not that trump card, but it is to be a</p>	<p>1 a quality audit that will promote efficiency while 2 maintaining the quality.</p> <p>3 MS. VIRAG: Lynn Turner?</p> <p>4 MR. TURNER: I'd echo the comments that 5 Dr. Carcello made as well as those that Ed made. I 6 think -- as well as the question that quite frankly 7 Ted asked, but never got an answer to.</p> <p>8 We have been doing these type audits for 9 the last few decades. SAS 55 came out in 1988. It 10 is not like it is something new. It is the exact 11 approach we used on many of the audits that have 12 failed miserably and resulted in mega claims against 13 auditors, not without reason.</p> <p>14 So I think there is a concern, because 15 when I compare the language in SAS 55 with the 16 language in this particular document, what I find 17 this is document is similar, but if anything lacks 18 some of the guidance in the old AS-5 and certainly 19 the guidance in the old audits guide. I know the 20 auditing standards board did a nice job of trying to 21 update that recently. Maybe that's something that 22 needs to be taken a look at as well.</p>
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<p>1 reference to what other experienced auditors might do 2 in similar circumstances. So there's no one answer 3 to anything. But on the other hand, there must be 4 ranges of reasonable and maybe there's something that 5 ought to be written into the standard along those 6 lines.</p> <p>7 Just picking up the efficiency point, it 8 is right that standards are concerned with quality 9 first and foremost rather than efficiency. I think a 10 standard setter, any regulator, cannot ignore 11 efficiency. And if one of the problems with AS-2 has 12 been inefficient implementation, it may not be just 13 dealt with in the way that Ed indicated by amending 14 the current standard. But it may be that there's 15 something about the current standard that breeds a 16 certain inefficiency, albeit that all the right words 17 are in all the right places.</p> <p>18 Sometimes it is easier to start again and 19 to indicate that fresher approach, provided you 20 accompany it with the message that Ed was concerned 21 about, that you should not be portraying this as some 22 how a rather relaxation, but a different approach to</p>	<p>1 But it is a continuation of exactly what 2 we've been doing, and there is nothing in there that 3 indicates really any significant change despite the 4 fact that there was a fairly thorough study done in 5 the '98, '99, 2000 timeframe in the O'Malley panel 6 report. If you go back and read the O'Malley panel 7 report, all the major firms sitting around this table 8 at that point in time did indicate they weren't doing 9 this notion of top down and stop, they were in fact 10 doing a full top down risk assessment.</p> <p>11 And the O'Malley panel came back and found 12 that there were two problems, a couple of problems 13 with that standard. One involved the attitudinal 14 issue and something has to be changed in the standard 15 if we're going to address attitudinal issues and how 16 auditors were approaching the risk assessment, which 17 clearly hasn't happened because if you look at the 18 last 4010 report, we see people not showing up for 19 the brainstorming session required by the audit 20 standards board.</p> <p>21 So clearly we haven't got that issue 22 addressed yet. Yet that's a major hole and</p>

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<p>1 shortcoming in this document.</p> <p>2 I think the other shortcoming which</p> <p>3 O'Malley aptly pointed out was the fact that there</p> <p>4 are procedural issues that haven't been adequately</p> <p>5 addressed in the standard nor in this one. And to</p> <p>6 that point, I really would like to echo what Craig</p> <p>7 said. I think this standard is still written up by</p> <p>8 and for auditors and doesn't consider adequately how</p> <p>9 you really get to some of these issues.</p> <p>10 The points Craig made about the auditors</p> <p>11 need to get outside their little box of ticking and</p> <p>12 tying and need to look at things like analyst's</p> <p>13 reports and other things that, what's going on with</p> <p>14 that company and the market price and understand</p> <p>15 where the market is on that.</p> <p>16 If you look at the cases, you know, in</p> <p>17 some of the major cases in Micro-strategy cases, the</p> <p>18 enforcement release notes, it was a Forbes article</p> <p>19 that highlighted the problem. The auditors didn't</p> <p>20 find it, yet a Forbes writer did. At Ride-Aid, the</p> <p>21 auditors didn't find it, but an SEC staff review from</p> <p>22 Washington found it. It is because they aren't</p>	<p>1 these restatements and gone through these material</p> <p>2 weaknesses in the last year and going back to 2004,</p> <p>3 that population of companies have underperformed the</p> <p>4 market indexes by 18 to 20 percent.</p> <p>5 And for this population of companies to be</p> <p>6 underperforming that index by that amount, that is</p> <p>7 humongous.</p> <p>8 The notion that we're relaxing and may not</p> <p>9 see that information getting out to investors so they</p> <p>10 know to stay away from those companies would be a</p> <p>11 travesty. Because that is a big cost and a lot more</p> <p>12 cost in terms of tens and hundreds of billions of</p> <p>13 dollars than what these audit fees even remotely come</p> <p>14 to.</p> <p>15 MS. VIRAG: Ted White.</p> <p>16 MR. TED WHITE: Thanks. First, to Lynn, I</p> <p>17 would echo what Joe and Harold said so eloquently.</p> <p>18 While efficiency is a fine term, that should not be</p> <p>19 the preeminent purpose here.</p> <p>20 I think from an investor viewpoint, of</p> <p>21 course, we want our money spent wisely. But the</p> <p>22 quality of the audit is first and foremost. I</p>
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<p>1 looking at the type of things that Craig mentioned.</p> <p>2 That's a gaping, gaping hole in this very</p> <p>3 particular document. And if you go out with the</p> <p>4 document as it is, especially with the tonal issues</p> <p>5 that Ed talks about, because there is no question in</p> <p>6 the most recent months even the Colorado state</p> <p>7 society came out with a summary of this thing and</p> <p>8 headed it up, PCAOB reduces testing.</p> <p>9 There's no question how this thing is</p> <p>10 going to be perceived by the public in general.</p> <p>11 That's quite frankly what I think your goal is. If</p> <p>12 that's your goal, you need to tell the world. But if</p> <p>13 that's the case, then I think you're going to have</p> <p>14 the same thing we had for the last two decades; and,</p> <p>15 eventually, the PCAOB will be held accountable for</p> <p>16 that.</p> <p>17 This is more than just, quite frankly,</p> <p>18 about accounting and auditing. We've done some of</p> <p>19 that research. Ours isn't hypothetical, we actually</p> <p>20 use your clients, Randy, and they provide us</p> <p>21 fantastic data, great data to work off of. But when</p> <p>22 you look at the companies that have gone through</p>	<p>1 personally found it very interesting that the</p> <p>2 pressure back on the system, particularly on the SEC</p> <p>3 and even here has been from the cost standpoint, not</p> <p>4 from the people paying the bills. In my opinion,</p> <p>5 investors ultimately foot the bills. You have not</p> <p>6 heard widespread complaints from investors about the</p> <p>7 cost of audits. Sure we want it efficient. But</p> <p>8 effective has to be number one. My perception is the</p> <p>9 staff has been aligned with us on that.</p> <p>10 Now, to the question earlier. I think the</p> <p>11 fairness part of it has been answered. I think I</p> <p>12 heard these people's opinion that it is an</p> <p>13 implementation problem or it has been an</p> <p>14 implementation problem in the past.</p> <p>15 The second part of my question, I would</p> <p>16 like some perspective from others here and from the</p> <p>17 staff as to what's different. If that is truly the</p> <p>18 case, do you agree with that? What is different now?</p> <p>19 Is the inspection process alone something that fixes</p> <p>20 that? Is the standards -- differences in the</p> <p>21 standard fixing that? I was alarmed by what Ed said.</p> <p>22 If there's a perception the PCAOB is relaxing</p>

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<p>1 standards, that's -- that doesn't seem right to me. 2 Maybe that's a bad perception, but -- maybe I could 3 open that question up. 4 I'd like to hear from the staff if you 5 feel you have addressed those problems from an 6 implementation perspective, should we be comfortable 7 with that? 8 MR. RAY: I'd be happy to make a couple of 9 comments with regard to your question. 10 Is this different? I think the question 11 is probably asked -- in substance, I would say it is 12 not different. I would say what we've -- are 13 attempting to do is really emphasizing more in this 14 standard the focus on risk and the focus on judgment. 15 And the attempt is to try to appropriately, again 16 emphasizing appropriately, permitting auditors to 17 exercise judgment in performing the internal control 18 audits. 19 I think what is different fundamentally, 20 what is different about the environment today is the 21 existence of the PCAOB and its inspection function. 22 We now do have an inspection, a quality inspection</p>	<p>1 out a little bit -- I think we have an audit approach 2 today, playing off of Joe's point, that assures the 3 good people are effective in trying to do it right. 4 I don't think we have an audit process today that 5 helps detect the bad people intent on doing it wrong. 6 And by that I say that as we look at the 7 audit approach today, first we look at, do we have 8 control processes in place to see that transactions 9 are recorded properly? 10 Do we have a financial organization with a 11 sufficient understanding of GAAP to prepare the 12 statements in accordance with GAAP? 13 And at the end of the audit process, we 14 get opportunities to improve our control processes 15 and correct errors. Again, the people who are trying 16 to do it right get assistance in getting it right. 17 But when you have a situation of 18 management override and outright fraud, I would offer 19 up that the audit approach as it stands today is 20 highly ineffective in detecting those kinds of 21 situations. 22 We had somebody be here -- I don't</p>
<p>Page 51</p> <p>1 function that is independent of the auditing 2 profession. And so I think that that is a very 3 significant factor to be considered as we complete 4 our rulemaking in this standard. 5 MS. VIRAG: We'll go to Craig Omtvedt. 6 MR. OMTVEDT: Thanks. I just want to add 7 a couple of comments. First, I think in terms of the 8 concern about this being viewed as a relaxing of the 9 standard, I can tell you that for those of us out in 10 the field, no one views it in that light. 11 I think universally we all view it as an 12 opportunity to have better quality audits and be more 13 effective. I think one of the concerns with AS-2 and 14 anybody who has done any degree of auditing will tell 15 you if you are looking across the board at everything 16 equally, you are going to dilute down your effort and 17 you're not spending your time in the areas that are 18 critically important. I think, again, the 19 modification you are making here is going to allow 20 for much more qualitative audits. 21 I personally think one of the things we 22 are all grappling with here -- and I want to lay this</p>	<p>Page 53</p> <p>1 remember his name -- who six months ago raised the 2 whole issue of how are we approaching the whole 3 aspect of fraud in the risk assessment process in the 4 audit process. 5 And I would suggest to you that until we 6 get that sorted out and get that right, all you're 7 giving people in the certification is comfort that 8 those who are trying to do it right got it right and 9 they've given you statements in accordance with GAAP. 10 I would offer up from an investor's 11 standpoint, I would suggest that the certification 12 should be -- and these are my percents now, so I'm 13 doing something ballpark -- the certification is 14 probably -- should be 30 percent, that the financial 15 statements are correct and proper and in accordance 16 with GAAP; and should be 70 percent assurance that 17 there isn't a fraud. 18 Now, I accept the fact that people aren't 19 going to catch everything. But I would say to you 20 today, the audits are woefully inept in detecting 21 fraud. 22 MS. VIRAG: We have time for two more</p>

<p>Page 54</p> <p>1 commenters, Charles Noski and Cynthia Richson. 2 MR. NOSKI: I am probably one of the few 3 people who has listened to everything this morning 4 and can say I agree with almost everything I've 5 heard. I've been an auditor. I've been a preparer 6 of financial statements. 7 Today I sit on several boards of directors 8 and chair two audit committees. I am listening 9 through my filter as an audit committee member and 10 trying to think about how AS-2 and AS-5 affect what I 11 do and how I think about the work of the auditors 12 whose client I am. 13 The thing that strikes me that is going to 14 be important if you go forward and adopt AS-5 is that 15 there needs to be a much more robust dialogue between 16 the independent auditors and the audit committee 17 about the risk judgments and the risk assessments 18 that the auditor is making, because my concern will 19 be -- as I listen to this -- and, of course, what 20 I've heard from both preparers and from audit firms 21 is that AS-5 is actually viewed as an expectation for 22 a much reduced level of work and more risk-based.</p>	<p>Page 56</p> <p>1 So please don't forget the audit 2 committees and our needs as you reflect upon the 3 requirements that you're proposing in AS-5. 4 MS. VIRAG: Thank you. 5 Cynthia Richson. 6 MS. RICHSON: Thank you. The discussion 7 this morning has been very insightful and very 8 interesting. I agree with a lot of what's been said. 9 But I do think Ed sort of hit it on the head. 10 I've been talking to a lot of audit 11 committee members, independent directors, and I think 12 the perception out there is really that the PCAOB is 13 relaxing the internal control standard and the 14 testing standard; and I think that's a very big 15 problem. 16 I think part of it -- even I, when I first 17 learned about this -- was surprised that the PCAOB 18 didn't say we've got two years of inspection reports 19 under our belt, of which, of course, only part of 20 that is public and parts are not. So we don't have 21 the full story even sitting here. But that they 22 weren't going to tweak it to make it more effective</p>
<p>Page 55</p> <p>1 And I, too, can remember back to the '80s and '90s 2 where that was code for doing less work and being 3 more competitive and reducing audit fees. 4 Having been a preparer and an audit 5 partner at one point in my career, I have different 6 perspectives on audit fees. As audit committee 7 chair, I have different perspectives on audit fees 8 because I am now more interested in the effectiveness 9 as well as the efficiency in the audit. 10 So I do think that as you think through 11 the communications between the audit firms and their 12 clients, the audit committees, that there should be a 13 much more robust dialogue about those judgments 14 because as audit committee members and as board 15 members, we are focused on risk assessment and risk 16 management and we spent a lot of time looking at, 17 frequently at some companies, looking at the 18 performance of audit companies versus others, and 19 trying to understand why we are better or worse than 20 the performance of others and challenging management 21 to explain to us why the financial statements reflect 22 the reality of their business and their performance.</p>	<p>Page 57</p> <p>1 and efficient. Instead it is a brand-new standard. 2 I think that's feeding into the perception 3 that this is -- the companies have complained loud 4 enough and often enough that we need to do something 5 about this crisis. And in talking to audit committee 6 directors and members, basically I hear horror 7 stories -- and these are widely circulated -- about 8 how the auditor came in and spent the entire day 9 looking through my day book to make sure that the 10 meetings I said happened really happened. In other 11 words, a complete waste of time. 12 And so you say, gee, that doesn't make any 13 sense. That strikes me as being very wasteful. On 14 the other hand, some good points were made by Ted and 15 Lynn. 16 I don't think any investor who ultimately 17 bears the burden of cost of these audits has 18 complained. For the most part, it is about audit 19 quality and that's where the focus ought to be. 20 When I hear the focus on the new proposed 21 standard is business efficiency, while we're all very 22 much in favor of efficiency, I think the bottom line</p>

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<p>1 really needs to continue to rest with quality of 2 audit.</p> <p>3 That's where the focus needs to be. And 4 if implementation really is the problem, that's where 5 we ought to be focused. What I'm hearing was the 6 experience of the '80s when risk-based assessment was 7 out there and used as a code word for doing less 8 work. I keep hearing about inexperienced auditors -- 9 which we heard at other SAG meetings are doing all 10 the work, young people out of college. I think that 11 needs to be addressed. And the fraud standard.</p> <p>12 We are on the heels again of the 13 back-dating stock option scandal. There has been no 14 breathing room of generally the PCAOB is being 15 allowed to do its job properly, it really is 16 functioning as independent of the audit profession, 17 accounting profession and we're getting it right.</p> <p>18 Incremental steps, we learn as we go 19 through inspections and other processes. I encourage 20 you to keep public perception in the back of what you 21 do as you go forward.</p> <p>22 MS. VIRAG: Do you want to comment?</p>	<p>1 we can say that, but the fact there is so much 2 misperception out there -- and I hope this comes out 3 in comment letters, please send your comment letters 4 in soon -- tells us that we probably need to look at 5 how we say things.</p> <p>6 But I guess I just didn't want the record 7 to go by -- and I know there are reporters in the 8 audience -- with it being un rebutted that in this 9 board member's mind, the proposal was not intended to 10 focus on saving costs, was not intended to water down 11 in any way the standard. If we said it wrong or got 12 it wrong, I hope commenters will let us know that.</p> <p>13 MS. VIRAG: We're going to go ahead and 14 give this a few more minutes.</p> <p>15 Christianna, do you want to talk?</p> <p>16 MS. WOOD: First, I want to echo the 17 comments of my fellow investors that as one of the 18 larger pension plans in the world, we are willing to 19 pay whatever it is, whatever it takes to get audit 20 statements right.</p> <p>21 And also the comments about identifying 22 gross fraud. I mean, that ultimately is the largest</p>
<p>Page 59</p> <p>1 MS. GILLAN: I should start out by saying 2 the views I express today are my own and not 3 necessarily the board's. I am a little bit perplexed 4 at some of the statements I'm hearing. I am the 5 first to acknowledge that perception of what one is 6 doing can sometimes be as important as what one is, 7 in fact, doing.</p> <p>8 And so when I hear that the perception is 9 that the PCAOB's proposed standard was intended to 10 water down or to relax standards in a way so that 11 there is not an emphasis on quality, that concerns 12 me.</p> <p>13 However, at the same time, I'm a little 14 bit at a loss to understand why people haven't read 15 the statements that the board made when we proposed 16 the standard, which was that our definition of 17 efficiency is, per se, doing the high quality audit 18 with the least resources possible.</p> <p>19 So that is the focus.</p> <p>20 Cindy, when you say that some people think 21 our focus is saving costs, no, it is not. It 22 absolutely is not. I'm not sure how much more clear</p>	<p>Page 61</p> <p>1 cost that we face. While there is plenty of talk 2 about AS-5 being a back-off or a back down, I think 3 really I appreciate Kayla's comments that we need to 4 recognize there has to be a balance. I want to say I 5 support the PCAOB in all of their efforts to find a 6 balance and to get this right.</p> <p>7 But what would really be the test is in 8 the future and how they respond to the audits in the 9 next few years, and the proof of the pudding will be 10 sort of right there in how they respond to whatever 11 changes or perceptions or changes in behavior that 12 are in the marketplace.</p> <p>13 I think it is incumbent upon them to hold 14 to what they believe they've done which is to try to 15 find the right balance.</p> <p>16 But I do want to say that -- you know, 17 acknowledge the perceptions, but say that ultimately 18 the PCAOB will have to send the right messages to the 19 marketplace. And I want to support them in being 20 firm on the effectiveness side as opposed to the 21 efficiency side of the balance.</p> <p>22 MS. VIRAG: I really mean it this time.</p>

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<p>1 We're going to take two last comments and then cut 2 this discussion off.</p> <p>3 Gaylen and then Arnie has a comment, and 4 then we'll be done.</p> <p>5 MR. HANSEN: I do agree with you. I don't 6 think we have gone overboard with that. I can say 7 from a CPA perspective that this standard is telling 8 us that we should apply more judgment. But I just 9 went through an inspection where almost every single 10 comment was addressed and critical of the judgment 11 that we did apply.</p> <p>12 So I think there's a balancing act and 13 that is where the inspection process comes in to 14 play.</p> <p>15 And I -- then just briefly, we had some 16 discussion about the audit committees and their 17 oversight function, and I think it's very important 18 that they be utilized properly. And in this process, 19 it can't be overstated how important that that is.</p> <p>20 I've seen a huge improvement in the 21 functioning of audit committees and the role that 22 they play. But on the other hand, I don't think you</p>	<p>1 interest as a company to make sure our investors have 2 the utmost confidence in our financial statements.</p> <p>3 We look to our internal processes and 4 people preparing those financial statements to ensure 5 those financial statements are accurate and present 6 fairly the financial position and condition of our 7 companies.</p> <p>8 But the way these audits were implemented 9 is where the rub is. And I just really don't know 10 how many of you have ever in recent years been in the 11 trenches to see the incredible level of detail we are 12 being put through.</p> <p>13 We can talk all we want at high levels 14 about risk-based approach. But put yourself in the 15 position of us within the company having to deal with 16 some of the -- what I'll call ridiculous questions 17 that were being posed to us because there wasn't a 18 lot of judgment being exerted or commented on the 19 part of many of the auditors.</p> <p>20 I think these words enable us to have the 21 appropriate dialogue with the auditors to get them to 22 focus and help them focus on areas where there is the</p>
<p>Page 63</p> <p>1 can expect audit committees to ever do -- to do 2 everything that -- to identify management override 3 and reduce to an acceptable level what might be going 4 wrong within these companies.</p> <p>5 You can't expect the audit committee to be 6 the back stop here. And so if that's what we have in 7 mind, I don't think that works. And especially not 8 some of the smaller filers where some of them don't 9 have audit committees to rely on. I think that we 10 need to kind of rethink that.</p> <p>11 MS. VIRAG: Arnie?</p> <p>12 MR. HANISH: I guess -- I'm trying to 13 figure out how to frame this.</p> <p>14 I find it regrettable that many people 15 around the table are trying to sort of tear away at 16 what I think the staff and the board have done an 17 admirable job of trying to address, issues over the 18 past several years that have been brought forward.</p> <p>19 I would challenge many of the people 20 around the table to maybe try to get into the 21 trenches and understand where some of the criticisms 22 have come from from the companies. It is in our best</p>	<p>Page 65</p> <p>1 greatest risk.</p> <p>2 And I guess maybe we need to -- as SAG 3 members -- have an auditing 101 lesson for some of 4 the members around the table to get people to really 5 experience what some us who are sitting here as 6 preparers have really complained about for the last 7 several years.</p> <p>8 We're willing to pay whatever it takes to 9 create a situation and an environment where the 10 investors truly do have confidence. But the level of 11 detail and the lack of focus on those areas where 12 many of us believe where there was a significant risk 13 of a material misstatement was really misplaced. And 14 I think this enables us to get the focus in the right 15 direction to provide what you all who are investors 16 want, the high quality audit that's efficient and 17 effective.</p> <p>18 Thank you.</p> <p>19 MS. VIRAG: At this point, I'm going to 20 put up the questions for the next session and people 21 can be thinking about those and we can kind of move 22 on to that.</p>

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<p>1 I see we already have a tent up. I'll</p> <p>2 call on Damon.</p> <p>3 MR. SILVERS: I apologize. I'm still on</p> <p>4 the last session. I hope you'll indulge me. I think</p> <p>5 Arnie's comment about who's in the trenches deserves</p> <p>6 some sort of response.</p> <p>7 In my capacity at the AFL-CIO, I have a</p> <p>8 variety of duties. Among them has been advising a</p> <p>9 preparer who was attempting to comply with 404, and</p> <p>10 doing so voluntarily.</p> <p>11 And I am deeply aware of what Arnie is</p> <p>12 talking about. I have experienced it firsthand. The</p> <p>13 AFL-CIO and I personally have been very determined in</p> <p>14 the dialogue about section 404 and AS-2 to be clear</p> <p>15 that we sympathize with much of what we have heard</p> <p>16 from the preparer community by what appeared to</p> <p>17 people of good faith about unnecessary burdens being</p> <p>18 imposed.</p> <p>19 And for that reason -- among others -- we</p> <p>20 were supportive of the general direction which the</p> <p>21 PCAOB and the staff took in considering changes to</p> <p>22 AS-2. And I think if you Google or whatever our</p>	<p>1 instructed, encouraged, hinted that merely the</p> <p>2 conclusion that somebody at the top of the company</p> <p>3 seems like an honest fellow is going to be enough</p> <p>4 to -- is going to be enough not to have to actually</p> <p>5 look at actual controls.</p> <p>6 I'm not enough of an expert to be able to</p> <p>7 get deeper into these things, but I keep getting</p> <p>8 ambushed by people who I think are to my right and</p> <p>9 turn out to be on my left on this and it makes me</p> <p>10 uncomfortable.</p> <p>11 I want to reiterate my support for the</p> <p>12 work of the board and the staff around this area</p> <p>13 which I think has been admirable, and has done great</p> <p>14 credit to the board and the expectations Congress had</p> <p>15 for the board when it put it in place. These issues</p> <p>16 being raised are serious ones and are what the</p> <p>17 comment period is for.</p> <p>18 We believe that the foundations, the</p> <p>19 conceptual pillars, so to speak, of what is being</p> <p>20 done here are correct. The board and staff need to</p> <p>21 be vigorous in rooting out any of these hints that</p> <p>22 under a new AS-2 or AS-5 auditors or preparers are</p>
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<p>1 comments in relationship to this process, you will</p> <p>2 see that's where we have been.</p> <p>3 And I don't think we're alone in that.</p> <p>4 The Council on Financial Investors is in a similar</p> <p>5 position. I think most thoughtful, long-term</p> <p>6 investors had a similar point of view. Unnecessary</p> <p>7 expense and unnecessary distraction from the business</p> <p>8 of running companies is not in our interest.</p> <p>9 What's happened, I think in the last few</p> <p>10 weeks as people have -- as people have read carefully</p> <p>11 the proposed draft standard is that -- and I think</p> <p>12 this reflects perhaps the tone of Arnie's comment</p> <p>13 about people tearing things down.</p> <p>14 What's happened here is that a number of</p> <p>15 concerns are being raised from a number of expert</p> <p>16 quarters, more expert than I -- academics,</p> <p>17 auditors -- about what the implications are of</p> <p>18 certain phrases in the proposed draft standard.</p> <p>19 In particular, the implication surrounding</p> <p>20 the question around the issuance of the reliance on</p> <p>21 the work of others and on the ability -- on whether</p> <p>22 or not all -- either issuers or auditors are being</p>	<p>1 going to be allowed to look the other way.</p> <p>2 MS. VIRAG: Joe Carcello.</p> <p>3 MR. CARCELLO: Before I make my next</p> <p>4 comment, let me reiterate something I said to some</p> <p>5 people yesterday. I think on balance the standard is</p> <p>6 a good standard. But I don't think we bring a whole</p> <p>7 lot of value if we come here today and just applaud</p> <p>8 you.</p> <p>9 So what I'm trying to do is point out</p> <p>10 things that I think are at least worth thinking</p> <p>11 about. And so that's what I'm trying to do.</p> <p>12 One comment I have related to this</p> <p>13 question and this again interacts with the SEC's</p> <p>14 guidance. The SEC's guidance talks about a strong</p> <p>15 indicator of a material weakness and ineffective</p> <p>16 oversight of financial reporting by the audit</p> <p>17 committee. And I clearly disagree with that. But no</p> <p>18 guidance is offered in either the SEC exposure draft</p> <p>19 or AS-5 as to what ineffective oversight looks like.</p> <p>20 I think this is particularly problematic</p> <p>21 because no evidence -- no evidence that I'm aware of,</p> <p>22 maybe you guys are aware of some -- that auditors are</p>

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<p>1 proficient in evaluating audit committee oversight of 2 financial reporting.</p> <p>3 And there's an actual conflict, given that 4 the audit committee now has the authority to hire, 5 fire, and compensate the external auditor.</p> <p>6 Also relating to company level controls is 7 the whole discussion we had this morning by a few 8 people about fraud. I would agree with what Craig 9 said. I think this is a major issue.</p> <p>10 In your exposure draft, there's a quote 11 from Craig Jonas that there needs to be increased 12 controls on fraud. I clearly agree with that. I 13 think AS-5 should have a more robust discussion of 14 this issue or the PCAOB should accelerate its 15 possible reconsideration of SAS 99, especially given 16 the numerous -- and as Lynn said -- really 17 rudimentary deficiencies documented in the board's 18 recent 4010 report.</p> <p>19 MS. VIRAG: Okay. I forgot to read the 20 question for everybody. The company level controls 21 discussion is based on the question, does the 22 proposed standard adequately articulate the</p>	<p>1 we should greatly reduce work because now it is no 2 longer required that we have evidence.</p> <p>3 It is in there. It is in the body of 4 standards that we have to comply with. I do recall 5 Kayla's point sitting in the open meeting when the 6 proposal was approved by the board. The tone of the 7 comments by each of the board members individually, 8 some of the questions of the staff I think were -- 9 will resonate with me. It was not about dumbing down 10 AS-2. It was not all about cost. It was trying to 11 strike that balance between preserving the quality of 12 the audit, protecting investors, and I still maintain 13 that. I think that the exposure draft largely 14 achieves that.</p> <p>15 We're going to have thoughtful comments 16 where we think little adjustments need to be made; 17 but on balance, I think it is a very good standard.</p> <p>18 I don't have any comments for the moment 19 on company level controls.</p> <p>20 MS. VIRAG: Vin Colman? 21 MR. COLMAN: Obviously, I agree with Bob's 22 comments. Maybe I'll move on to your question as</p>
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<p>1 appropriate consideration of company level controls 2 and their effect on the auditor's procedures?</p> <p>3 Bob Kueppers?</p> <p>4 MR. KUEPPERS: I didn't think you were 5 serious about this question. I was going to answer 6 the last one. So I might as well take the license 7 you've given me.</p> <p>8 I guess I want to make one point. Maybe a 9 final point hopefully on this issue of tone.</p> <p>10 If you compare AS-2 and the exposure draft 11 AS-5 and look at things like, well, principle 12 evidence is gone, a large portion disappeared, you 13 might be able to -- you could turn that to be that we 14 don't have to do much work in order to issue our 15 opinion.</p> <p>16 But I'm not troubled by that simply 17 because where that leaves us as auditors is that we 18 need to have sufficient competent evidential matter 19 to support our opinion. That is true for the 20 financial statement audits. It is the same standard.</p> <p>21 By introducing, as AS-2 did, new terms, 22 you know, I think all of that does not signal to me</p>	<p>1 opposed to going beyond.</p> <p>2 I think what you're going to see in our 3 comment letter and other comment letters is a couple 4 things. The interaction between the management 5 guidance from the commission and your guidance and 6 perhaps this is one area if you look at the guidance 7 there's some actually very good discussion in the 8 SEC's guidance with respect to the direct and 9 indirect level of company level controls, and the 10 impact that would have.</p> <p>11 And then you look at the PCAOB standard 12 and where the level of precision -- actually 13 paragraph 43, if you look at paragraph 43, it is not 14 necessarily in the assessment, it is in deciding how 15 much to test. Right?</p> <p>16 And perhaps that needs to be moved up, and 17 that should be part of your assessment. So that 18 drives the decision-making around, you know, how 19 aligned the company level controls are, your 20 evaluation, and then determine the nature, time, and 21 extent of your procedures.</p> <p>22 This is a very delicate plan where I think</p>

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1 people could begin to misunderstand similar to a
 2 number of the comments that are here where the
 3 implementation is going to be key. I think being
 4 able to -- it was discussed, I remember, at great
 5 length with respect to the COSO for small business
 6 and other areas. I think one of the examples came up
 7 around segregation of duties.

8 This alignment of company level controls
 9 and the level of precision and how it drives the
 10 nature, time, and extent of procedures is very
 11 delicate. I ask you to continue to think about how
 12 it is aligned with the SEC guidance on both sides.

13 So that when we talk about efficiency, the
 14 most efficient way to do this is for management to be
 15 able to consider what they do and to have the
 16 auditor, the whole spirit of being able to understand
 17 what management is doing, being able to rely to the
 18 extent necessary, and adjust your needs to the time
 19 and extent of your procedures.

20 MS. VIRAG: Randy Fletchall?

21 MR. FLETCHALL: Thank you, Sharon. This
 22 is an area I have concerns with, too. I think

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1 clearly it is very, very important to any kind of top
 2 down risk-based approach that you start early on in
 3 the level of company level controls. I think that is
 4 clear in the guidance. That sets the right stage.

5 What I am concerned about is similar to
 6 something Vin mentioned. Many company level controls
 7 kind of indirectly affect whether you get something
 8 right. We haven't found in the past that many that
 9 directly tell you if you have effective company level
 10 controls, if financial statement assertions are
 11 correct.

12 So I think it is one of those areas,
 13 again, if you clearly have ineffective company level
 14 controls, an auditor has a lot of work to do. Where
 15 you think you have effective company level controls,
 16 again you can't infer that that means transactions
 17 are processed correctly and everything is accurate.

18 I made the statement in a SAG meeting, a
 19 couple of SAG meetings back when we had a panel
 20 talking, going back a few years ago to when we were
 21 looking to become more efficient and looking at
 22 methodology. We looked around the world, very hard,

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1 to find a lot of company level controls that operated
 2 with a precision that if they were in place and
 3 operating effectively, you said that gives me
 4 assurance the financial statements are correct.

5 My only concern is what you have written
 6 is accurate, it sets out the possibility of relying
 7 on company level controls. My fear is like an
 8 expectation that you actually find company level
 9 controls that directly affect the accuracy of
 10 financial statement assertions and therefore you are
 11 finished and that gives you the efficiency, when I
 12 think it is dangerous to rely on company level
 13 controls.

14 MS. VIRAG: Sam Ranzilla?

15 MR. RANZILLA: Well, this may be the first
 16 time I've ever agreed with Randy Fletchall.

17 I could not articulate it any better than
 18 you did, but --

19 MR. FLETCHALL: I agree with that.

20 MR. RANZILLA: But I would say that if
 21 there were two flash points in this standard that if
 22 I were to look today and think forward to two years

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1 from now, the SAG meeting where we have -- hopefully
 2 it is a SAG meeting, not another SEC-PCAOB roundtable
 3 on 404 -- but at some point, we're obviously going to
 4 have to see how standard 5 holds up.

5 And ultimately, I think the success of
 6 auditing standard number 5, from an auditor's
 7 perspective, is in two areas: One is getting the
 8 risk assessment correctly. Secondly, whether or not
 9 company level -- how we deal with company level
 10 controls, we're able to discern the difference
 11 between those that are directly linked to assertions
 12 and those that are indirectly linked to assertions
 13 which have very different effects on our audit
 14 approach. And then even those that are directly
 15 linked to the assertions, is the precision there
 16 close enough so that you can ultimately conclude that
 17 little or no more work is needed on that company
 18 level control.

19 I think how the auditors implement that
 20 aspect of AS-5 would depend upon whether we're coming
 21 back here in two years having a discussion about the
 22 need for more efficiency or the fact that we just

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1 don't get it and we're not doing enough work.
 2 And so my suggestion is that that is a
 3 place where the SAG could provide maybe some more
 4 guidance in terms of -- and I think -- I can tell you
 5 for a fact, my firm would be willing to participate
 6 in some sort of practice aid or the like, because I
 7 do honestly think as I look at my own firm's
 8 implementation of AS-5, that is the place where we're
 9 either going to get it right or we're not.
 10 MS. VIRAG: Jeff Steinhoff?
 11 MR. STEINHOFF: I'll let go of Sam's
 12 echoing of Randy's remarks. This is a very delicate
 13 area. It tells you a lot if they're bad. So if the
 14 high level controls are bad, you know you've got a
 15 serious problem. It tells you less if they're good.
 16 They are somewhat difficult to assess. I
 17 think probably more guidance is necessary. Probably
 18 more guidance is needed in order to tell an auditor
 19 where their reliance would enable them to reduce
 20 testing.
 21 And it perhaps is not clear what evidence
 22 one must pull together to support the assessment

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1 itself, much less the reliance on it and reduction.
 2 I do have a concern that the way the standard is
 3 drafted, people might think that there's a lot of
 4 focus on this versus other things. And I think
 5 somewhere in the standard, in paragraph 17, as it was
 6 noted to me, the auditor must test the company level
 7 controls, very definitive.
 8 And I think a lot of auditors will read it
 9 as if this is really the keystone. And once I tested
 10 those, and I find those are all right, I can greatly
 11 limit everything else I do.
 12 I'm not sure that's what you want to
 13 convey, but I do have a concern that there's a need
 14 to have a proper balance and to perhaps provide some
 15 more guidance in this area either through the
 16 standard or in another way.
 17 But to make it very, very clear what this
 18 tells you and what it doesn't and how much priority
 19 and how much weight the auditor must place on this at
 20 the end.
 21 MS. VIRAG: Richard Dietrich?
 22 MR. DIETRICH: As an academic, my role

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1 often is to ask a question. So in thinking about Ed
 2 Trott's comments earlier, and in this message that it
 3 sends, and Kayla's comment, when I look at this
 4 issue, my question is, do we think that this proposal
 5 is intended to increase the effectiveness or the
 6 efficiency? And if we think it is really intended to
 7 increase effectiveness, it would be helpful to
 8 explain how we think it will do that.
 9 Otherwise, it will be interpreted as
 10 increasing efficiency by telling the auditors if you
 11 do this, you need not do other things.
 12 I think that's the point that is being
 13 made here.
 14 MS. VIRAG: Lynn Turner?
 15 MR. TURNER: As usual, I agree with Randy
 16 and Sam.
 17 (Laughter.)
 18 MR. TURNER: Nice articulation, Randy.
 19 But I think there is a risk here that goes back to
 20 some of what Craig said earlier about risk at the
 21 company level or whatever, and how that translates --
 22 how then the auditor translates that down into more

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1 of the detailed basic work.
 2 Once again, there's less guidance in this
 3 standard than what was in the prior standard, and
 4 even the prior standard didn't work. And under the
 5 prior standard, we know time and time again that the
 6 auditors were unable to make that assessment at the
 7 top. And yet you're making that assessment at the
 8 top very, very key, and I actually think it is very,
 9 very key.
 10 If it isn't working there, so far as I'm
 11 concerned, you can cut it off there and forget about
 12 testing the rest of the stuff and go on from there.
 13 It is a total waste of time to be doing that. And
 14 yet at the end of the day, when we look at all the
 15 various cases and you can name one after the other,
 16 you know, for whatever reason, that never got
 17 assessed right. And yet as we heard here not too
 18 long ago, this standard really hasn't changed and
 19 isn't different.
 20 So my question is, why are we using the
 21 same standard that didn't work that people were never
 22 able to assess, and where we are given less guidance

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<p>1 than before? What is it that we are looking at to 2 turn around and say that it didn't work? 3 Maybe back again to some of Craig's 4 comments about the fraud stuff. It doesn't seem to 5 be there's enough focus on those controls that deal 6 with fraud. 7 Quite frankly, this gives you almost no 8 guidance, very little definition of what is meant by 9 the control environment where the audit committee is 10 so key. There's hardly a mention of the audit 11 committee in this particular one, and the importance 12 of that role and what the expectations are with the 13 auditor with respect to that. 14 So again, it looks to me like we are very 15 much close to what we've had for the last 20 years, 16 which I suspect will give us pretty much the same 17 result in the next 10 to 20 years. I just wonder why 18 we're going down that path unless we want to repeat 19 history, which it seems like we are destined to turn 20 around and do with this document. 21 By the way, Arnie, I sat on three audit 22 committees and gone through this nitty-gritty in the</p>	<p>1 of a company. That's one thing we have seen 2 consistent with most of these big frauds. And in my 3 view, there are very few controls, when you have 4 collusion and override, that will prevent these 5 frauds and detect them. 6 I think it is important we be in agreement 7 with what will prevent these controls, perhaps fraud 8 hot lines to prevent these frauds and make sure we 9 don't use reliance on controls as an excuse to 10 decrease our substantive testing. 11 MS. VIRAG: Kimberly Gavaletz? 12 MS. GAVALETZ: I want to reflect on prior 13 conversations we've had relative to this topic and 14 some of the key points that I think you've tried to 15 include in the standard revision relative to the 16 timeliness and the timing of when you looked at the 17 company level controls. 18 I think one of the points we haven't quite 19 discussed in here was early in the process. We've 20 alluded to it, saying that basically you look at 21 something, decide not to test. I think it is 22 important that some of our prior conversations said</p>
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<p>1 last few years and chaired three. I appreciate what 2 you say. I agree that you don't want people going 3 overboard, but this standard is a repeat of history. 4 MS. VIRAG: Cynthia Cooper. 5 MS. COOPER: I agree with most of the 6 comments made. It is dangerous when we rely on 7 company controls to reduce the amount of substantive 8 testing. I think that is one of the reason that some 9 of these big frauds in the past have not been 10 detected through the external audit that I think the 11 frauds like WorldCom, Health South, other big 12 scandals are more likely to be detected through more 13 rigorous substantive testing and more forensic 14 audits. 15 I think it is important to make sure that 16 while auditors are testing company level controls, we 17 don't forget the risks we are trying to meet. 18 Everything should go back to risk in the end, and we 19 should make sure we keep our eye on what these 20 company level risks are. 21 One is management override of controls, 22 collusion that goes all the way to the highest levels</p>	<p>1 these weren't focused to the end where they might 2 have been able to help with the scoping. 3 I tend to agree if they're really good, 4 you don't have to test. If they're really bad, they 5 do give you signals and that's where you need to go. 6 What I heard was there were a lot of experiences and 7 this might have changed through the last year or so, 8 but a lot of experiences with company level controls 9 being looked at at the tail end of the audit, which I 10 felt was inappropriate and didn't give you the 11 information. They're very informative from the 12 outset. That is an important part you have to have 13 incorporated. 14 I think Lynn touched on it. Whoever does 15 this, it is very important to really look at the 16 company level controls and to discern what's really 17 being told by that. It will take a lot of senior 18 level support to go do the level of substantive 19 testing which I agree is necessary to really get to 20 the foundation of things. 21 It also involves looking at what the audit 22 committee role is. There is a little bit of conflict</p>

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<p>1 in there that has already been pointed out.</p> <p>2 I think it is a place that does need to be</p> <p>3 focused on at the right time in the overall -- by the</p> <p>4 right people and rightly resourced, so you can get</p> <p>5 the most impact out of it. Otherwise, if you're</p> <p>6 doing it, I'm not sure what the reason you're doing</p> <p>7 it. If everybody is external to it and independent</p> <p>8 of it, it is another check. But a potential leap too</p> <p>9 far down in the process.</p> <p>10 MS. VIRAG: John Kellas.</p> <p>11 MR. KELLAS: Thank you.</p> <p>12 Perhaps I stumbled slightly over</p> <p>13 paragraphs 16 and 17. One reason was the reason Jeff</p> <p>14 raised. I stumbled over the must test. It is wrong</p> <p>15 to read that sentence without reading the whole of it</p> <p>16 because you do say that they are important, blah,</p> <p>17 blah, blah.</p> <p>18 I think when we were revising the</p> <p>19 international risk standards a few years ago, we came</p> <p>20 under a great deal of pressure to acknowledge that</p> <p>21 company level and overarching controls were capable</p> <p>22 of providing the auditor the assurance they needed.</p>	<p>1 And so when things go wrong, people aren't</p> <p>2 saying how could it be that the business failed to</p> <p>3 provide this. But again, that doesn't do the audit</p> <p>4 work. It is the basis of good audit. I think the</p> <p>5 control environment, upper level controls are in</p> <p>6 exactly the same category. They deserve more focus</p> <p>7 than they've had in the past.</p> <p>8 But they are underpinning a good audit not</p> <p>9 substituting for other matters.</p> <p>10 MS. VIRAG: I'm going to go ahead and put</p> <p>11 up the next question. We'll get started before the</p> <p>12 break. We have 12 or 13 minutes before then to start</p> <p>13 with comments on scaling the audit.</p> <p>14 The question is, does the discussion of</p> <p>15 size and complexity within the proposed standard</p> <p>16 appropriately describe when and how the auditor</p> <p>17 should scale the audit?</p> <p>18 Joe Carcello?</p> <p>19 MR. STEINHOFF: Yes.</p> <p>20 MS. VIRAG: I promise to call you next,</p> <p>21 Jeff.</p> <p>22 MR. STEINHOFF: I said yes. That was</p>
<p>Page 87</p> <p>1 At the end of the day, we did resist that.</p> <p>2 I think our position is much closer to what Randy</p> <p>3 said at the beginning.</p> <p>4 They are a very negative indicator, if</p> <p>5 they're rubbish, but even though they're brilliant,</p> <p>6 they are unlikely to do your work for you. At the</p> <p>7 end of the day, the only question to be asked about</p> <p>8 control is, is it good enough to achieve the</p> <p>9 objectives I'm looking for.</p> <p>10 I think you say that in your document</p> <p>11 somewhere if I remember correctly.</p> <p>12 That's the point to be focused on rather</p> <p>13 than -- well, as I say, read the whole sentence. It</p> <p>14 did make me think maybe the message was a little bit</p> <p>15 strong on the overarching controls.</p> <p>16 It is rather like the point Lynn raised</p> <p>17 earlier about knowledge of business, external</p> <p>18 information and so on. I think if there's one -- you</p> <p>19 know, over my years in auditing, one thing I think I</p> <p>20 came to the conclusion that is really, really</p> <p>21 important is that the auditor understands the</p> <p>22 business program.</p>	<p>Page 89</p> <p>1 my comment.</p> <p>2 MR. CARCELLO: I have a few comments on</p> <p>3 what you guys are suggesting as it relates to smaller</p> <p>4 public companies. And one of the things suggested in</p> <p>5 the exposure draft is that small companies' control</p> <p>6 objectives can be met through daily interaction of</p> <p>7 top management. For maybe most companies this will</p> <p>8 work.</p> <p>9 What if senior management is corrupt? For</p> <p>10 example, we know from the research that fraud is more</p> <p>11 prevalent when the founder is involved with top</p> <p>12 management. That's been well documented. Smaller</p> <p>13 entities are likely to have continuing founder</p> <p>14 involvement.</p> <p>15 So that would seem to be a risk to me.</p> <p>16 The exposure draft also suggests that inquiry and</p> <p>17 observation of a control may provide sufficient</p> <p>18 evidence of whether a control is effective even</p> <p>19 without documentation. If fraud is going on, top</p> <p>20 management is not going to tell you that during an</p> <p>21 inquiry. The very fact of observing behavior changes</p> <p>22 that behavior.</p>

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<p>1 Finally, in my opinion, the standard seems 2 to suggest -- although I will recognize it is not 3 explicitly stated -- that smaller entities can get by 4 with relatively unsophisticated financial reporting 5 staff. But even if a business enters into simple 6 transactions -- no derivatives, no leases, no defined 7 benefit pension, post-retirement benefit plans -- 8 they still will have deferred transactions, and 9 they'll still have to prepare a statement of cash 10 flows.</p> <p>11 FAS 109, 1048, FAS 945, not to mention any 12 applicable EITFs and staff positions are complex 13 standards requiring high level skills.</p> <p>14 MS. VIRAG: Jeff, did you want to comment 15 more than your yes?</p> <p>16 MR. STEINHOFF: No. 17 (Laughter.)</p> <p>18 MS. VIRAG: Gaylen Hansen.</p> <p>19 MR. HANSEN: As I read the standard, it 20 appears to me that scaling applies to all companies. 21 I think the standard says it does. It is not just 22 small companies. I'm not sure it really articulates</p>	<p>1 Kueppers mentioned it earlier in his comments. It 2 seems to me that that's making somehow implicitly an 3 argument about cost-benefit analysis of the internal 4 control testing relative to the size of the company.</p> <p>5 Alternatively, the term complexity that's 6 used is really talking about the need for evaluation 7 and judgment. And I think of those things as very 8 different. It is quite probable they are correlated. 9 Smaller companies may be less complex. But I think 10 those two things, at least in my mind, are muddled.</p> <p>11 The other thing Gaylen Hansen mentioned 12 earlier was this two-person entity. And so I asked 13 myself what if one of the two people quit. And then 14 we had a one-person entity.</p> <p>15 Do we really have to say that we expect 16 every entity to have effective internal controls? 17 What if it is a one-person entity?</p> <p>18 MS. VIRAG: Damon Silvers?</p> <p>19 MR. SILVERS: When the question comes up, 20 do we really expect every entity to have effective 21 internal controls, that's like hitting a button. 22 Before I do my automatic playback on that</p>
<p>Page 91</p> <p>1 how that works, other than it is based on risk which 2 I think that should be the approach.</p> <p>3 Then just to speak to what was said by 4 Jeff, I mean, I agree with the idea that you have to 5 have competent people internally. But let's face it, 6 in a small business, in the small companies, it is 7 really 95 percent people and 5 percent systems and 8 not the other way around like in the bigger entities.</p> <p>9 I mean, I do know that there are specific 10 technical issues that have to be handled by those 11 competent individuals, you have to have internally. 12 But it is not as pervasive in the larger companies.</p> <p>13 So I think the idea of scaling is what is 14 going to make this work for the smaller businesses.</p> <p>15 Some of them don't have deferred taxes. I 16 know my clients don't because they don't make any 17 money. They're losing money. I wish they had 18 deferred taxes. 109 is particularly difficult for 19 them.</p> <p>20 MS. VIRAG: Richard Dietrich?</p> <p>21 MR. DIETRICH: Two questions about this. 22 One, I am unsure about the word "size" in there. Bob</p>	<p>Page 93</p> <p>1 subject, I want to say a word about just the way in 2 which the board approached this issue of 3 scalability. As a conceptual matter, I think this 4 is exactly -- as a broad conceptual matter, exactly 5 the right way to do it. Not to say some companies 6 the auditor ought to have a scaled approach and 7 others they shouldn't, or anything like that.</p> <p>8 And also not to fall into the trap of 9 saying that any particular financial metric is a 10 proxy for complexity. There are relatively large 11 companies that are relatively simple and relatively 12 small ones that are relatively complicated.</p> <p>13 Financial service companies that are small may be 14 more complicated, and a biotech start-up might be 15 large on a market cap basis. So I think this is an 16 area -- my prior comment talked about getting the 17 foundations of the pillars right.</p> <p>18 I think this is an area, together with the 19 notion of shying away from a design audit approach, 20 and a few other areas, where the board and the 21 commission have gotten this right.</p> <p>22 Again, I think we need to be wary here</p>

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<p>1 that in the interstices and details, the standard 2 messages are being sent that somehow smaller or 3 simpler companies shouldn't be audited.</p> <p>4 And that a perfunctory kind of -- that it 5 is okay for either the company's assessment, the 6 SEC's business, or the auditor's audit ought to be 7 kind of a pro forma exercise. It absolutely should 8 not. I think if the collective opinion of those who 9 know best is there are any words in this that point 10 in that direction, they ought to be changed.</p> <p>11 Now for the auto-play part. Anybody who 12 wants to have access to the public's money, whether 13 it is a one-person company or a no-person company -- 14 right -- should be able to say they have adequate 15 internal controls. I do not believe that anyone 16 should be allowed to call up one of our union members 17 on the phone at home and offer them a security for a 18 company which does not have adequate internal 19 controls. I do not believe anyone can say they 20 should with a straight face.</p> <p>21 Thank you.</p> <p>22 MS. VIRAG: Leroy Dennis?</p>	<p>1 does have those controls. I think the messages have 2 to be that this is really in the company's control as 3 to how much they want to invest in their systems.</p> <p>4 And if they invest the proper amount, as 5 their shareholders would want, then they could have a 6 more effective process. If they decide to invest a 7 minimal amount, I would guess proportionally their 8 audit fees and the opinion to get to the control is 9 going to go up.</p> <p>10 MS. VIRAG: We are going to go to break. 11 When we come back, I will start with Ted and Lynn. 12 Everyone can give thought to the question.</p> <p>13 MR. RAY: Before you get up from your 14 seats, one thing I neglected to mention in my opening 15 remarks this morning is that we do have time set 16 aside beginning at 5:00 o'clock for emerging issues, 17 if there are any. I have not received any 18 suggestions for any issues that we ought to discuss 19 in that session to date, but if you have any you 20 would like to discuss, please see me during one of 21 the breaks and we can see if we can get that teed up. 22 With that, we do have a half an hour</p>
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<p>1 MR. DENNIS: I want to comment a little 2 bit on some of the things Joe mentioned. I agree 3 with him. I'm concerned about the messages. I 4 support the standard and where it is going. When I 5 look at smaller companies, complexity is going to 6 drive what the words are going to do, not necessarily 7 the size. A company that invests in its controls, 8 whether it is a small company or a large company, is 9 probably going to have a more efficient process 10 performed by the auditors.</p> <p>11 But if I look at a smaller company that 12 has -- where you are relying on management to make 13 sure controls are implemented properly, and to your 14 point of how do you test management, you've got to 15 rely on the audit committee. The audit committee has 16 to be more effective probably in that environment 17 than in an environment where you have much more 18 robust transactional controls.</p> <p>19 If you have a situation where you don't 20 have that oversight of the management by an effective 21 audit committee, I think you're going to have 22 proportionally more harm done than a company that</p>	<p>1 break. We'll see you back here at 11:00 o'clock. 2 Thank you.</p> <p>3 (Recess.)</p> <p>4 MR. RAY: If everyone would please take 5 your seats, we would like to resume the meeting. 6 I declare the break officially over and 7 turn the floor back over to Sharon.</p> <p>8 MS. VIRAG: I think we will start with Ted 9 White.</p> <p>10 MR. TED WHITE: I had a quick statement on 11 the question. First, I agree with the statement. I 12 agree with the approach. My single comment here is 13 that I would urge the board and the staff to 14 resist -- even strongly resist -- any approaches that 15 would, under the guise of scaling an audit, come up 16 with a two tiered process or anything that has lower 17 standards just because a company is small.</p> <p>18 I believe what Damon said is that size and 19 complexity are two separate issues, and you can't 20 assume because a smaller company is small, it is less 21 complex and vice versa. Both of those concepts 22 should be included in this standard, remain in it.</p>

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1 And I'm a little bit worried -- I guess a
 2 lot worried -- about pressure on the PCAOB to scale
 3 an audit down, meaning giving lower standards to
 4 smaller companies. I think that's wrong. That's it.
 5 That's my statement.
 6 MS. VIRAG: Bob Tarola?
 7 MR. TAROLA: Thank you, Sharon. I think
 8 the concept around scalability, looking at risks and
 9 focusing appropriately on those risks, allowing the
 10 company to show the auditor how they do control risk
 11 is the absolute right direction. I think it applies
 12 to all size companies.
 13 I think it is an effectiveness improvement
 14 across-the-board that the focus on the higher level
 15 controls on the enterprise risk will allow the
 16 auditor, I believe, to more effectively conduct an
 17 audit, more effectively identify the areas where real
 18 work is needed to make sure that management is doing
 19 a proper job on serving its investors.
 20 I think the trade-off between a better
 21 understanding of enterprise and high level risks will
 22 result in some conclusions that previous testing at

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1 lower levels may not be necessary. In my view,
 2 that's also an effectiveness conclusion and I'm
 3 supportive of where the board is going here.
 4 I think, however, the perception that it's
 5 purely for efficiency is an incorrect perception. It
 6 is really an improvement in effectiveness.
 7 MS. VIRAG: Other comments?
 8 Craig Omtvedt.
 9 MR. OMTVEDT: Just a couple of thoughts
 10 here and I will get back on my soapbox on 404 for a
 11 moment. I want to reiterate the point I made earlier
 12 this morning. I really truly don't believe that
 13 there's an audit process today that is effective in
 14 detecting fraud, and I think that there should be,
 15 and I believe that is the principal interest of the
 16 investment community.
 17 I think what we have today is a process
 18 that -- again, as I said earlier -- I think assures
 19 the good people are getting it right. I would
 20 suggest to you that what has happened here is that in
 21 place of effective audit procedures for getting at
 22 fraud, we have substituted a 404 standard that says,

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1 well, if we do a lot to document all the controls at
 2 a grass roots level, then we really can be pretty
 3 well assured that we will not have fraud. I would
 4 suggest to you that the opposite is quite the case.
 5 I think if you look at the body of
 6 evidence, it would say there has never been a major
 7 fraud as a result of poor control of inventories at a
 8 plant location or the potential is somebody wrote off
 9 5 or 6 million dollars of inventory because they
 10 weren't determining obsolescence. I think, further,
 11 the problem we have here is because of the standard
 12 we have in 404 today, we have an issue in our public
 13 markets in that foreign investors don't want to issue
 14 here because of the expense and the difficulties
 15 associated with trying to comply with 404.
 16 So as I look at the situation, I think
 17 that if we move to get stronger and better standards
 18 for detecting fraud, I believe that if we deal with
 19 the whole issue of 404 and scaling that to a standard
 20 that makes more sense, we then will do a great deal
 21 in resolving the disconnect we currently have between
 22 how the standards are working for large public

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1 companies and how we ultimately will deal with small
 2 companies.
 3 Thanks.
 4 MS. VIRAG: Lynn Turner?
 5 MR. TURNER: First, let me correct the
 6 record that the reason companies aren't coming here
 7 has nothing to do with complexity. Two major Wall
 8 Street firms, Goldman Sachs and Thompson Financial in
 9 recent weeks have indicated that regulation has
 10 nothing whatsoever to do with that in this country.
 11 Having said that --
 12 MR. OMTVEDT: Excuse me, but I refute that
 13 for the record.
 14 MR. SILVERS: Go call Goldman.
 15 On the complexity issue, in a way, this
 16 ties back to what we talked about earlier in terms of
 17 translating what you think of the people at the top
 18 and the job they're doing into how far down you go
 19 and what you do, including not only in small
 20 companies but big companies.
 21 And when you think back to a typical
 22 audit, probably most of us would assess things like

<p>Page 102</p> <p>1 PP&E additions and intercompany accounts as low risk. 2 And yet those were the items that were actually 3 manipulated at both Health South and WorldCom and 4 we've heard discussions about accrued payroll and 5 accrual for vacation allowance were two of the 6 accounts manipulated at Qwest to turn around and make 7 the numbers. 8 So one of the complexities that the 9 standard really doesn't adequately address or get 10 into is how is it that you translate -- how is it 11 that you go about making that risk assessment and 12 make sure that you don't make the same mistakes that 13 others have made, that those type of things are 14 automatically low risk. And I don't have to spend 15 much time on them when, in fact, some of those 16 accounts have turned out to be very, very 17 problematic. 18 And I think there's very little -- 19 actually, there's probably no discussion in the 20 document, if you will, about the fact that you may 21 have items that you typically would assess at low 22 risk and most people would assess at low risk. And</p>	<p>Page 104</p> <p>1 there in the first place. And that's back to my 2 point about we need better fraud detection 3 methodologies in the audit process. 4 MR. TURNER: I think in a lot of cases 5 that's true, Craig. But in the WorldCom case when 6 you started to look at the intercompany accounts -- 7 and Cynthia probably knows this better than me -- you 8 didn't have intercompany accounts capturing the data 9 in the way controls need to capture the data. 10 That was just not override. That was the 11 type of systems and the information in a company that 12 you didn't have especially in light of all the 13 roll-ups and consolidation that occurred. 14 MS. VIRAG: Damon Silvers has his sign up. 15 We'll move to him. 16 MR. SILVERS: Many years ago, I had the 17 experience of sitting in a small room at the 18 Securities and Exchange Commission without any 19 windows. 20 (Laughter.) 21 NEW SPEAKER: That was special for you, 22 Damon. There are only two of them, but they have</p>
<p>Page 103</p> <p>1 yet in reality, they turned out to be extremely high 2 risk and been evident in multi-billion dollar 3 misstatements that have cost investors tens 4 of billions of dollars. 5 And somehow this document needs to come to 6 grips with that issue and talk about the fact that, 7 you know, just because you or I may think it is low 8 risk doesn't necessarily mean it is. You need to be 9 thinking about that and that's where in the O'Malley 10 panel report, they did a nice job of saying that's 11 where the auditor that's thinking about putting on 12 that skeptical hat, and is that type of situation 13 potentially existing here. You don't have that here, 14 which, quite frankly, takes us back to repeating 15 history again. 16 MR. OMTVEDT: I apologize for speaking out 17 of turn here. But, Lynn, back to your point, I agree 18 with your point. But the issue here isn't the 19 absence of control, it is more a case of management 20 override. And once you have management override or 21 you have collusion to circumvent a control, then you 22 killed the effectiveness of the controls that were</p>	<p>Page 105</p> <p>1 very bright lights. 2 MR. SILVERS: That's right. I was sitting 3 on John's side of the table, so to speak, in that 4 room. Hopefully, John will stop me if I say anything 5 I'm not supposed to. It was a long time ago. 6 And there was an individual on the other 7 side of the table -- 8 MR. TROTT: Stop. 9 MR. SILVERS: There was an individual on 10 the other side of the table who neglected to ensure 11 that his firm had counted the inventory in the 12 warehouse. And that individual was crying. Turned 13 out -- I think it wasn't his responsibility to see to 14 it. But that failure to do so allowed other people 15 to misrepresent what was in that warehouse, and there 16 were serious consequences to the investors in that 17 modestly sized public company. 18 That's why we need to have a standard here 19 that will basically direct both companies and 20 auditors to do their very, very best to figure out 21 what's important and what isn't, and not presume that 22 it isn't important if it turns out that it might well</p>

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<p>1 be.</p> <p>2 Nobody wants to be in that room on that</p> <p>3 side of the table having that discussion, certainly</p> <p>4 not the investors who lost the money.</p> <p>5 Now, the -- this is another one of these</p> <p>6 things -- there's a lot of people who paid a lot of</p> <p>7 money to get other people to assert nice finely</p> <p>8 published bound volumes that somehow the work of this</p> <p>9 board is imperiling the efforts -- the Congress of</p> <p>10 the United States protecting the investing public in</p> <p>11 the United States is somehow imperiling the national</p> <p>12 interest because Chinese parastatals and central</p> <p>13 Asian start-up companies feel leery about coming to</p> <p>14 our markets to issue their stock.</p> <p>15 While I certainly understand that if</p> <p>16 you're someone like, say, Wilbur Ross, who has a</p> <p>17 large investment in Chinese parastatals which he</p> <p>18 would like to take public in our markets, you might</p> <p>19 be able to buy an infinite number of academics to buy</p> <p>20 that result.</p> <p>21 I fail to see what anything like this has</p> <p>22 to do with the national interest, particularly, I</p>	<p>1 In the case of WorldCom, the other thing</p> <p>2 that went wrong is the external auditors really</p> <p>3 shared too much information in terms of their scope</p> <p>4 with management, so they lost the element of</p> <p>5 surprise.</p> <p>6 What happened was when they told</p> <p>7 management we're coming in to test construction in</p> <p>8 progress and here's how we're going to test it, a lot</p> <p>9 of these entries were sitting in CIT. Management</p> <p>10 went in, moved the entries around in small dollar</p> <p>11 increments that would be less likely that the</p> <p>12 external auditors would detect it.</p> <p>13 And the other thing that Andersen did was</p> <p>14 they relied heavily on analytical review. So they</p> <p>15 would come in each quarter and look at line costs as</p> <p>16 a percent of revenue and compare that with prior</p> <p>17 quarters and everybody was in line. It was flat at</p> <p>18 42 percent. Andersen looked at it and said there are</p> <p>19 no anomalies, everybody looks good. They didn't</p> <p>20 compare it to a peer company like AT&T and others</p> <p>21 which I think is an excellent suggestion Craig</p> <p>22 mentioned. They did little substantive testing</p>
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<p>1 find it offensive the suggestion that retired steel</p> <p>2 workers whom no one would lift a finger to protect</p> <p>3 when their jobs were going overseas ought to put</p> <p>4 their retirement assets at risk to subsidize the jobs</p> <p>5 of investment bankers.</p> <p>6 I think that's precisely what is being put</p> <p>7 on the table here.</p> <p>8 MS. VIRAG: Cynthia Cooper.</p> <p>9 MS. COOPER: I want to follow up on what</p> <p>10 Craig and Lynn said about WorldCom. If you look at</p> <p>11 the WorldCom fraud, these entries were post-close</p> <p>12 on-top entries. Management closed the books and</p> <p>13 records at the end of the quarter. They said here is</p> <p>14 where we are. Here is what we told the analysts we</p> <p>15 were going to make this quarter. Then they booked</p> <p>16 these huge on-top post-close entries.</p> <p>17 In the case of the external audit, Arthur</p> <p>18 Andersen did not have access to WorldCom's accounting</p> <p>19 system. They relied on management to provide them</p> <p>20 with the schedule they needed. They didn't go into</p> <p>21 the system and query for these on-top entries. If</p> <p>22 they had, the large entries would have fallen out.</p>	<p>1 because they relied on the strength of internal</p> <p>2 controls.</p> <p>3 For example, in the area of property, they</p> <p>4 only had six capital additions in the first half of</p> <p>5 the year and none in the second half of the year</p> <p>6 based, in my view, on over-reliance on internal</p> <p>7 controls.</p> <p>8 So if any of you guys have questions you</p> <p>9 want to ask me, I'd be happy to answer them.</p> <p>10 MR. RAY: I think this discussion about</p> <p>11 fraud is very enlightening. You will have a chance</p> <p>12 to talk about fraud this afternoon at our session.</p> <p>13 Maybe if we can -- I think we need to try to focus on</p> <p>14 these questions that we have teed up. I think this</p> <p>15 is a very important one to make sure we are heading</p> <p>16 in the right direction on the scale. If we could try</p> <p>17 to focus on this, that would be very helpful.</p> <p>18 Thanks.</p> <p>19 MS. VIRAG: Ed Trott.</p> <p>20 MR. TROTT: Why do I need this section in</p> <p>21 the document at all if I'm using a risk-based</p> <p>22 approach? Wouldn't that cover all these thoughts?</p>

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1 Am I trying to send another message?
 2 I don't even know why you have this
 3 section.
 4 MS. VIRAG: Can we hear from other SAG
 5 members?
 6 MR. OLSON: There's some hesitation by the
 7 staff to answer that, and let me tell you why I think
 8 that's the case. I have encouraged them -- there's
 9 not a word in the standard after thousands and
 10 thousands of hours, there isn't a word in that
 11 standard that has not been carefully thought through.
 12 And the real value, from our perspective, from this
 13 session, is to learn from this group what we have
 14 communicated. We are very interested in your
 15 response and I've encouraged our staff here to not
 16 get involved in a dialogue where here is what we
 17 meant to say.
 18 That would, I think, diminish the value of
 19 this discussion. It is extraordinarily valuable to
 20 hear from you how you read it and especially where
 21 you find inconsistencies or that might be viewed as
 22 either an inconsistency or a duplication.

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1 I think that's why we're not giving this
 2 specific response to your question.
 3 MS. VIRAG: John Morrissey?
 4 MR. MORRISSEY: No. Thank you.
 5 MS. VIRAG: Arnie?
 6 MR. HANISH: I agree with Ed, actually.
 7 I'm questioning why it's entitled scaling the audit
 8 for smaller companies. I think if you look at
 9 paragraph 9, if you read it the way I read it, that
 10 would be all part of a top down risk-based approach.
 11 I don't think we want to lead any of the readers or
 12 any companies or any of the auditors to believe there
 13 should be a separate standard for smaller companies.
 14 I don't believe there should be a different standard
 15 for smaller companies. There should be one approach.
 16 I might recommend we take out the header
 17 or the title as far as scaling the audit for smaller
 18 companies and try to incorporate and embed the
 19 principles under paragraph 9 and subsequent
 20 paragraphs throughout the entire document as opposed
 21 to trying to draw a distinction. There should not be
 22 a distinction, in my view.

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1 MS. VIRAG: John Morrissey.
 2 MR. MORRISSEY: Thanks. I guess to answer
 3 at least from my view when I read through this
 4 section, I completely agree with Ed's thoughts as to
 5 why we need this. An appropriately risk-based
 6 approach, this should get swept up in that notion.
 7 But I think what I have seen and heard in
 8 formal discussions anecdotally was that there was a
 9 notion that AS-2 was a one size fits all and the
 10 firms as they tried to implement this, had a level or
 11 standard that provided a certain degree of rigidity
 12 that made it difficult, particularly for companies
 13 that didn't have the same robust internal control
 14 environments that, say, a larger company might have.
 15 So when I read this, I thought this was
 16 the attempt to try to reinforce the notion that one
 17 size doesn't necessarily fit all. And I thought in
 18 that context, it was helpful.
 19 I didn't interpret this as a, we need a
 20 two-tiered standard that we need a big company audit
 21 standard and a small company audit standard. I
 22 thought it was to reinforce the notion -- at least

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1 that's the way I read it. When I looked at it as a
 2 preparer, that's my take away from reading this
 3 section. If that's the concern, I think the points
 4 should be taken under consideration by the staff as
 5 they craft the final document.
 6 I don't think that was the intent. If
 7 people interpret it that way, I think that's probably
 8 the wrong interpretation.
 9 MR. RAY: Kimberly Gavaletz.
 10 MS. GVALETZ: John, I concur with your
 11 last statement. You ought to look at how it is
 12 stated. If it came across as a multi-tiered
 13 approach, I don't believe that was the intent.
 14 Everything put in AS-5 -- and those who were in this
 15 body last year as I joined the body know I was
 16 against us doing anything. I thought we needed to
 17 maintain AS-2, continue to go forward, listen to the
 18 comments. I felt like -- as has been expressed by Ed
 19 and others in the room -- there was the flexibility
 20 in the standard to do all the things we talked about
 21 from the beginning.
 22 I felt like we were getting a sufficient

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<p>1 number of comments and I believe that's where the</p> <p>2 staff thought that some of these things needed to be</p> <p>3 addressed to answer where there was more work going</p> <p>4 on than needed to be done. Not to let there be less</p> <p>5 work, but to allow the people hung up on specific</p> <p>6 words to see their comments and to incorporate</p> <p>7 guidance that I felt was sufficient on its own into</p> <p>8 this standard being separate, which I also thought</p> <p>9 was sufficient.</p> <p>10 That being said, we are at the point where</p> <p>11 we have something on -- out there, and I think it is</p> <p>12 there. It is trying to be clarifying. I do believe</p> <p>13 overall it might have been an overstep to give a new</p> <p>14 number to the standard. It is implying it is so much</p> <p>15 more drastically different, and I do believe it was</p> <p>16 to incorporate some of these subtleties that I</p> <p>17 believe were already in the document.</p> <p>18 Relative to that, I think relative to</p> <p>19 size, the question that is up here, we already had</p> <p>20 the flexibility in there. I agree with John. But if</p> <p>21 that unintended consequence that people see the</p> <p>22 tiered approach, because I think in some cases</p>	<p>1 people. I'm afraid people could look at that and</p> <p>2 say, well, you're below a certain size cutoff without</p> <p>3 really thinking through rigorously the issues of</p> <p>4 complexity. And it is very likely a company could be</p> <p>5 below those size cut-offs and be complex and really</p> <p>6 should have an audit scale up and vice versa.</p> <p>7 And although the standard certainly talks</p> <p>8 about that, by putting in specific dollar amounts</p> <p>9 with the imprimatur of an SEC group, although this</p> <p>10 was privately funded, I think runs the risk of being</p> <p>11 potentially misused.</p> <p>12 MS. VIRAG: Lynn Turner?</p> <p>13 MR. TURNER: I agree with Ed's question</p> <p>14 and Arnie's answer. I think if you're really serious</p> <p>15 about a principle-based type of approach -- which I</p> <p>16 agree with -- I think you start taking yourself very</p> <p>17 much so into a rule-based approach when you start</p> <p>18 defining here's the size of companies, putting in</p> <p>19 numbers. There's no way at that point it isn't</p> <p>20 principle-based, it is rule-based, and you start to</p> <p>21 lose it.</p> <p>22 I would suggest that a better way to deal</p>
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<p>1 smaller companies, you may have to do additional work</p> <p>2 in areas that you wouldn't have done because they</p> <p>3 were done a little differently.</p> <p>4 So we are where we are. I think we have</p> <p>5 listened to folks. There was the cry for some</p> <p>6 clarification. The staff has answered that cry. We</p> <p>7 need to clean up any unintended consequences from</p> <p>8 that, but move forward without, you know, a major</p> <p>9 revamp of the activities.</p> <p>10 I think that's actually what you presented</p> <p>11 to us, though it has been labeled in a much grander</p> <p>12 scale.</p> <p>13 MS. VIRAG: We have about five, maybe 10</p> <p>14 minutes left on this subject. I'm going to try to</p> <p>15 get everyone whose tent card is up. Joe Carcello?</p> <p>16 MR. CARCELLO: I think in general, the</p> <p>17 standard is pretty well written. The one thing I</p> <p>18 would suggest for you to think about, though, is on</p> <p>19 paragraph 9, the note, footnote number 6, where you</p> <p>20 make specific reference to size cutoffs.</p> <p>21 On the SEC advisory committee, on smaller</p> <p>22 public companies, I'm afraid that could be misused by</p>	<p>1 with that would be right up front, lay out in bullet</p> <p>2 point, what your key principles or objectives that</p> <p>3 you are trying to get to which aren't there and I</p> <p>4 think should be in any principle-based standard.</p> <p>5 Tell the auditors, these people around the</p> <p>6 table, what it is you expect them to achieve. You</p> <p>7 expect them, first bullet would be, to use risk-based</p> <p>8 approach that focuses on material items that are, in</p> <p>9 fact, considered to be the more risky.</p> <p>10 Bullet 2, expect them to get enough</p> <p>11 knowledge about the business such that they can make</p> <p>12 decisions in light of industry and peer groups. They</p> <p>13 have to gain knowledge of the controls that are there</p> <p>14 and put in place.</p> <p>15 The third bullet would be based on that,</p> <p>16 you expect them to scope the testing and perform</p> <p>17 enough testing so they get evidence from wherever,</p> <p>18 their own testing, or use others, but they've got to</p> <p>19 get sufficient testing to provide basis for telling</p> <p>20 the public whether those -- you know, those controls</p> <p>21 exist and are working with reasonable assurance.</p> <p>22 The fourth bullet on reporting.</p>

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<p>1 Come back and tell -- here is the 2 objective we expect you to achieve in reporting. 3 This is another area where this is very much 4 rule-based. You give the auditors one reason why is 5 particular type report, you don't give them 6 flexibility. You talk about giving them judgment, 7 latitude to tell the public something about controls 8 if they think there's something that needs to be. 9 Put those objectives right up front and 10 lay those out. It gives you more flexibility in the 11 later part of the document to have more room for 12 judgment. They know what they have to come back and 13 achieve. It increases your ability to use judgment 14 but tells everybody what they have to get to and what 15 they will be held accountable to at the end of the 16 day. 17 When you get there, you don't need this 18 two tiered standard which you have in this case, one 19 for small, one for large. 20 I certainly encourage you to go down that 21 path. 22 MS. VIRAG: Gaylen Hansen.</p>	<p>1 the standard. I don't think anybody has picked on Ed 2 yet. I think we should call this AS-2-R and I think 3 it should be just fine. 4 MR. TROTT: Which firm are you with? 5 MR. KUEPPERS: One substantive comment. I 6 hear the debate about the -- I don't believe this is 7 two standards in one cover. I really don't. The 8 question of whether or not you should call out or 9 have separate importance to the smaller company, I 10 think is one that is the result of all the 11 sensitivity and the politically charged environment 12 around this. 13 We know the SEC is determined not to 14 exempt. We have to find a way to make sure the 15 thousand companies that are not yet in the system 16 have an audit approach that is AS-5 compliant at the 17 end of the day. 18 The one thing this might provide, though, 19 is a portal to plug in additional guidance at the 20 small end of the spectrum. I'm not talking about 21 size. I'm talking about complexity. I think that's 22 the biggest driver. I think it might be helpful if</p>
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<p>1 MR. HANSEN: As I said earlier, as Arnie 2 pointed out, I think maybe changing that title to 3 make sure that people don't get misled, that the 4 scaling related solely to small companies would be 5 something to -- footnote 6, I don't understand what 6 that did anyway. It is sitting there. Sort of gives 7 you an idea of sizing. But how it translates to the 8 standard, I'm not quite sure. 9 The only other point I had to make on this 10 particular issue was I think the same thing could be 11 said of the multi-location testing. At the point -- 12 back on -- in AS-2, when the standard sort of said 13 that you had to cover a larger portion, and then 14 that's taken back, that's in the same boat with what 15 Ed's talking about. 16 This is risk-based. You're going to make 17 those decisions on all locations. Under that sort of 18 principle-based approach, that wouldn't be any 19 different than any other scaling decision. 20 MS. VIRAG: Bob Kueppers? 21 MR. KUEPPERS: I wanted to pick up on a 22 comment Kimberly made about not needing to renumber</p>	<p>1 all the audit firms that have not done one of these 2 audits yet because their clients are in the 3 non-accelerated filer category, additional guidance 4 for getting it right at the less complex company 5 level, this would be the place in the standard that 6 guidance would sort of plug in. 7 I think that small business audit guide, 8 even though in principle I'd love to have one thing 9 and have the whole continuum be scaling. I think we 10 need to provide extra help for a big part of the 11 population that is not in the system under 404. 12 MS. VIRAG: Damon Silvers? 13 MR. SILVERS: First, I want to echo what 14 Bob just said about the appropriateness of that kind 15 of guidance for the non-accelerated filers. I think 16 that most investors look at the non-accelerated 17 filers and say we want the same principles to apply 18 to everybody, but in real life, when people are doing 19 things, it looks different when you talk about a 20 company of 30 people than a company of 30,000 people. 21 That's just a different thing. There ought to be 22 some help to the firms and to the companies that</p>

<p>Page 122</p> <p>1 are -- will be engaging in that. We believe it is 2 important they engage in it. That kind of help would 3 be a good thing.</p> <p>4 The -- I also think the point -- I want to 5 support the point John Morrissey made about why this 6 section is in there. I think that it's -- while it 7 is correct, Ed's analysis is correct at one level. 8 Ed isn't generally correct at all.</p> <p>9 But in this respect, there is a point to 10 this which is about the fact that many people of good 11 will in the preparer community have felt as though 12 they've operated in an environment under AS-2 in 13 which there's nobody listening to the realities of 14 their business and the relative complexity or lack of 15 complexity of their business.</p> <p>16 I think it is important for the integrity 17 of the whole process that those concerns be taken 18 seriously and addressed. I think that's what this 19 section tries to do. I think with some degree of 20 success.</p> <p>21 The issue that remains, in my opinion, 22 about this section is the potential for the</p>	<p>Page 124</p> <p>1 having guidance -- I know it is here -- whether 2 there's other guidance being worked on, I think could 3 be helpful.</p> <p>4 Specifically, though, I think we had a 5 lengthy conversation about the risks of company level 6 controls, and the degree of directness or 7 indirectness, the risk of how much that would either 8 drive no testing or the nature, time, and extent of 9 the type of testing of process level controls.</p> <p>10 I would ask that you take that 11 conversation and marry it to what is in paragraph 12 12 about whether or not we are helping or hurting in 13 some of that.</p> <p>14 MS. VIRAG: The next subject is a 15 discussion of the differences between management's 16 evaluation process as management would follow it 17 based on the SEC's proposed guidance and the process 18 the auditor would follow under the board's proposed 19 standard. The question is would management's process 20 for evaluating its internal control under the SEC's 21 proposed guidance and the process the auditor would 22 follow under the board's proposed standard raise</p>
<p>Page 123</p> <p>1 misunderstanding that this section constitutes, as I 2 think Bob just said, two standards under one cover.</p> <p>3 There's got to be absolutely no ambiguity 4 about that question. It is one standard. Right. It 5 provides -- allows the auditor of the mega company to 6 think about the relative complexity of the mega 7 company compared to other mega companies, but does 8 not give any special breaks to the auditor of the 9 small company in terms of the standard.</p> <p>10 So I think to the extent that the title, 11 for example, leaves any ambiguity, that title needs 12 to be altered.</p> <p>13 I also think with respect to the footnote 14 issue and the issue of throwing numbers any place, 15 there needs to be greater clarification that while 16 certainly numbers like market cap and total revenue 17 are relevant to the question of complexity, they're 18 not determinative.</p> <p>19 MR. COLMAN: I just want to support what 20 was said by Bob and Damon, to be able to say there's 21 a standard and a standard and scale it all the way 22 down. That said, there's unique characteristics,</p>	<p>Page 125</p> <p>1 implementation difficulties for the auditors or 2 management? If so, how can these difficulties be 3 addressed or managed?</p> <p>4 Howard Johnson?</p> <p>5 MR. JOHNSON: Silence is golden on this. 6 I haven't spoken to anything yet and I thought this 7 might be a good one since there's a break in the 8 action here. The interesting thing to me on this SEC 9 is now for management to allow other forms besides 10 testing of controls, following things like monitoring 11 just daily interaction.</p> <p>12 First of all, there's a lot of value to 13 that. I think we hit on it this morning. Craig 14 mentioned more than once that we have to get the 15 auditors out of the box and do other things besides 16 just appear to be too far down in the details.</p> <p>17 And there's a lot of stuff you can do for 18 monitoring of the control environment. You still 19 need to take a look at it once in a while to make 20 sure there isn't something that's changed 21 significantly and also do things like analysis to see 22 what's going on outside the bell-shaped curve, really</p>

<p style="text-align: right;">Page 126</p> <p>1 weird stuff. Either too good to believe or just off. 2 Some of that stuff you get through doing 3 things like monitoring. Not just testing. 4 So I kind of have to say I like the SEC's 5 extra verbiage and allowance. I think from being 6 down in the details, seeing what's happened both on 7 management's side and public accounting's side, when 8 I was with Lowe's, it is a big sigh of relief to have 9 other options than doing testing to make sure the 10 control environment is really what it appears to be. 11 MS. VIRAG: Kimberly Gavaletz? 12 MS. GVALETZ: I would agree with Howard's 13 comments relative to a broader spectrum of evidence 14 that supports -- that management has a control 15 environment. The one concern I still will echo to 16 the group is keeping the ever increasing potential 17 for divergence between what the SEC guidance is and 18 what the PCAOB's. 19 This reconciliation going forward is 20 something we're going to have to be very vigilant 21 about. I applaud the SEC for keeping it sufficiently 22 almost principles-based. I know there's a clamor for</p>	<p style="text-align: right;">Page 128</p> <p>1 They are there every day. They are running the 2 company. It makes sense. One of the criticisms 3 before was auditors were driving management to do 4 things because there was only AS-2. 5 To the extent there are differences, 6 that's probably good. A concern would be if there 7 are so many differences that people can't communicate 8 and we have gaps or duplication because as we manage 9 these total costs down, I can go back to, Charles, 10 what you said earlier, about your role as an audit 11 committee member. 12 We think it is terribly, terribly 13 important to make sure there is a thoughtful 14 collaboration between management teams who we might 15 have turned into auditors, let them manage, but take 16 on the responsibility they have under 404 and 17 certifications as Bob said to do what they do well. 18 There is optionality, flexibility. All the effort 19 might be reduced in some way, so what a management 20 team chooses to do will have an effect on what an 21 auditor does. What we are preaching to our people is 22 a thoughtful collaboration, sharing of details,</p>
<p style="text-align: right;">Page 127</p> <p>1 more detail from others. I would hesitate in telling 2 people exactly how to do the things. I think you 3 tried to do that. I hope we don't keep doing that. 4 I think that gives more potential for things to 5 diverge. 6 I would just lay out as an indirect answer 7 to this, as we stand right now, there are kind of the 8 right levels, but I see that it exists out there, 9 there's the potential long term and we're going to 10 get very -- to not let that occur and keep the 11 reconciliation and test ourselves before either is 12 released on making sure those are clear, so we don't 13 confuse the management side of the things that are 14 trying to implement. And then the external auditors 15 who are trying to assess management and then getting 16 things out of sync. We do have the potential for 17 that. 18 MS. VIRAG: Randy Fletchall? 19 MR. FLETCHALL: There clearly are 20 differences between the PCAOB's proposed standard and 21 SEC's proposed guidance. But let's face it. 22 Management is in a different place than auditors.</p>	<p style="text-align: right;">Page 129</p> <p>1 collectively management does its job, auditors do 2 their job, and collectively it is done in the most 3 efficient manner. 4 MS. VIRAG: Vin Colman? 5 MR. COLMAN: Just adding to that, we are 6 doing the same thing. I think there should be 7 differences. That's a good thing. I think it will 8 affect the process for which there's been so much 9 criticism, meaning to make sure you understand what 10 has management done in their process before you start 11 even the assessment that's in AS-5. Understand what 12 they have done. How they support their assertion. 13 And it could assist in many aspects of 14 AS-5 whether the nature, time, and extent of what 15 you're going to do, your risk assessment, the use of 16 work. Others, time -- there's a lot of areas that 17 will affect. 18 We're going to educate our people to try 19 to understand what management is doing first and 20 engage in that rather than run first, decide what 21 you're going to do, and figure out how you can 22 reconcile back to management. That would be a bad</p>

<p>Page 130</p> <p>1 process. I think everybody agrees with that. Some 2 of this is like we talked about this morning around 3 the implementation. 4 That said, there are a couple of areas 5 where I do think it would be helpful to have just 6 from an efficiency standpoint, whereby when the 7 auditor comes in, they're speaking from the same song 8 card. One was -- we touched upon before, the 9 discussions around the entity level of control, the 10 degree of precision in the PCAOB standard and the 11 documentation that is in the SEC standards. Elements 12 in both of them are very good. I think coming 13 together would really help the process ultimately 14 from both an effectiveness and an efficiency kind of 15 standpoint. 16 Second, around the strong indicators of a 17 material weakness. There's breakages between the 18 two. I think some people could think there are 19 subtle messages being sent through there. I'm not 20 sure there are. I think it needs to be -- have 21 collaboration about -- so that the management's 22 trying to decide what are material weaknesses and</p>	<p>Page 132</p> <p>1 I further believe that the discussion of 2 important risks should be held with the audit 3 committee to make sure the management team and the 4 outside auditor are in line -- or in alignment as to 5 all of the important risks. And, in fact, how 6 they're going to be -- how they are mitigated and how 7 we will each do our job in making sure that we can 8 provide a certification we have to provide. 9 The -- heretofore, there has been very 10 little collaboration. It has been pretty much a 11 gotcha situation. My hope is we can somehow avoid 12 that and management teams and auditors could 13 basically work together to protect investors by 14 agreeing on important areas to review and 15 complementing each other in some way toward achieving 16 satisfaction that risks are appropriately mitigated. 17 MS. VIRAG: Jeff Steinhoff? 18 MR. STEINHOFF: I think it would be normal 19 to have some differences in the way this is stated to 20 the respective parties. Management has a much 21 different responsibility than the auditor has. And 22 it's important that management realize that it is the</p>
<p>Page 131</p> <p>1 what an auditor is trying to decide. Quite frankly, 2 they should be aligned. 3 MS. VIRAG: Leroy Dennis? 4 MR. DENNIS: I want to expand a little bit 5 on what Vin said and what Lynn said earlier. Lynn 6 talked about putting principles in the introductory 7 part of AS-5. 8 I think having the same type of 9 understanding of the SEC guidance would help to make 10 sure the two standards are aligned at least in 11 principle and would serve to eliminate any confusion 12 that they are not. 13 MS. VIRAG: Bob Tarola. 14 MR. TAROLA: Thank you. 15 This one worries me. 16 I was glad to hear from Randy, Vin, and 17 others words like collaboration, engagement, and sort 18 of working together to identify the important risks 19 and the way risks are mitigated. I think that's a 20 healthy exchange that I don't think has existed to 21 the degree necessary in the past, and I think this 22 will drive that.</p>	<p>Page 133</p> <p>1 one responsible for ensuring there be adequate 2 controls. It is a fundamental management role. 3 It is not a process management should be 4 going through to comply with what an auditor wants. 5 It is good business practice. It helps protect the 6 business as well as the shareholder. But it is a 7 fundamental management responsibility. 8 So if that is always placed in mind, then 9 the auditor's role is to provide a check over whether 10 management is reasonably carrying out its 11 responsibility and it shouldn't be the auditor 12 driving management. And both parties should be 13 really having a constant dialogue as to those things. 14 We have faced some of that at the federal 15 government, where management just solely wants to 16 find out what does the auditor think. So if the 17 inspector general or GAO has issued a report, 18 management will jump right on and report that as a 19 weakness. They feel in some quarters as long as they 20 have done that, they are compliant with the laws. 21 That is very far from the truth. 22 They have a responsibility to assure on an</p>

<p>Page 134</p> <p>1 ongoing basis that things are working well, and I 2 think that it's all right for the language not to be 3 exactly the same in every paragraph. And as long as 4 there's a clear understanding, I think this can work 5 well. 6 MS. VIRAG: Any other comments before we 7 move on? 8 I think we're going to break for lunch at 9 this point a few minutes early. If everybody could 10 meet back here at 1:20 that would be great. 11 (Whereupon, at 11:51 a.m., the meeting was 12 recessed, to reconvene at 1:20 p.m., this same day.) 13 14 15 16 17 18 19 20 21 22</p>	<p>Page 136</p> <p>1 work of management and relying on the work of 2 internal audit, particularly internal audit that 3 follows the standards for the professional practice 4 of internal auditing. 5 I thought that was a good demarcation. 6 That seems to have gone away in AS-5. 7 In the discussion paper you gave us to 8 prepare for today, you have a statement in there 9 essentially focusing on competence and objectivity, 10 which I agree is the focus. It is not on the job 11 title. I agree clearly that is by far the least 12 important. I don't know if I completely would ignore 13 it. In my mind, job titles do matter somewhat 14 because they create a mindset. 15 I think there is a fundamental difference 16 in mindset between internal audits and management 17 because they may involve compliance with a set of 18 professional standards. When you rely on the work of 19 internal audit, there's in many cases a set of 20 professional standards, a certification, a code of 21 ethics, a code of responsibility that those people in 22 many cases have internalized and they're also bound</p>
<p>Page 135</p> <p>1 AFTERNOON SESSION 2 (1:20 p.m.) 3 MR. RAY: I would like to restart the 4 meeting since most people are sitting down. If the 5 remaining few could please take your seats, I will 6 turn this back over to Sharon Virag to continue our 7 discussion on internal control. 8 MS. VIRAG: The next topic for discussion 9 is using the work of others. We have two questions. 10 You can take them in any order you like. 11 First, does the proposed standard meet the 12 objective of removing unnecessary barriers to using 13 the work of others? 14 Does the proposed standard promote better 15 integration of the audits? 16 Joe Carcello to start us off. 17 MR. CARCELLO: Since no one else wants to 18 talk, I'll take the microphone. 19 Again, I think what you have here is 20 reasonable in many ways. I guess the one concern I 21 had is in AS-2, at least my read of AS-2, there was a 22 clear demarcation in my mind between relying on the</p>	<p>Page 137</p> <p>1 to observe. 2 That's not necessarily the case when you 3 rely on management. So I think kind of equating them 4 is potentially dangerous. 5 I think the language that you had in AS-2 6 was in many ways better than what you have here. 7 MS. VIRAG: John Morrissey? 8 MR. MORRISSEY: I would like to -- first 9 of all, I agree with everything Joe just said. 10 I think looking back on my days as an 11 internal auditor, the internal audit function can be 12 very, very valuable to an organization. As you 13 mentioned, they have their own ethics requirements, 14 professional standards; and in a properly structured, 15 organized audit function where they report directly 16 to the audit committee, they are in many ways 17 accountable to the audit committee and investors 18 directly. 19 I think this is something that really 20 deserves serious attention and recognition that it's 21 worth investing in an internal audit function from a 22 public policy standpoint. And to elevate them --</p>

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<p>1 because they are different from management, they 2 should be treated differently from management. 3 I think the opportunity within the 4 standard to call them out and give them expert 5 recognition when properly structured, when properly 6 trained, when properly organized, provides an 7 opportunity for management to invest in good internal 8 controls at the most important level, and that's at 9 the people level. I think if you look at this, you 10 can't come out strong enough in order to encourage 11 that, at least in my view. 12 MS. VIRAG: Gaylen Hansen. 13 MR. HANSEN: When it talks about whether 14 the auditor accepts the testing of another 15 individual, it needs -- I would hope that it would be 16 a little bit more specific. It says some testing is 17 required. Some testing seems a little vague to me in 18 terms of the extent. I don't know if you want to get 19 that cookbook-ish about it, but I think something 20 more than "some" would be a good direction. 21 MS. VIRAG: Kimberly Gavaletz? 22 MS. GAVALETZ: One comment on the section</p>	<p>1 I'm a little concerned with the principal 2 evidence provision being eliminated. It's not 3 necessarily that I think that the wording in AS-2 was 4 necessarily right. Again, I always kind of go to the 5 end point and worry about the potential consequences. 6 I asked some people this yesterday; let me 7 pose this to the group. If management personnel 8 appear objective and competent, could they gather the 9 principal evidence, and not just for the audit of 10 internal control but for the financial statement 11 audit? That really worries me. 12 With the audit of internal control, if we 13 do not get that right, that doesn't automatically 14 mean there's a misstatement in the financial 15 statements. But if there's a problem with the 16 financial statements and we don't get it right, 17 there's no backstop, no safety net. It is a change 18 not just for ICFR but a change for the audit of the 19 financial statements. 20 Here we're saying we can rely on 21 management to essentially do the work to audit the 22 financial statements if they appear objective and</p>
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<p>1 that really started to deal with this, in removing 2 the barriers to using the work of others where you 3 address the principal evidence. 4 I just wanted to comment that I agree with 5 eliminating the principal word and evidence because 6 it is the right level of evidence you need for 7 whatever is there. I think principal evidence, that 8 goes along with everything was causing some 9 behaviors, that meant you couldn't rely on the work 10 of others to the extent if they had what they 11 considered the principal evidence, you had to redo 12 that particular work. 13 The importance is understanding the 14 fidelity of the evidence, understanding the quality 15 and qualifications of the person making that and the 16 objectivity of the partner making those judgments. 17 I think you did help clarify some and 18 remove barriers with how you addressed that 19 particular area under principal evidence. 20 MS. VIRAG: Joe Carcello? 21 MR. CARCELLO: Let me respond and follow 22 up on what Kimberly just said.</p>	<p>1 competent. If so, if that's true, what do we need 2 the auditors for? 3 And roll back the clock to the late 4 Nineties. Don't you think most everyone would have 5 described Mr. Fastow and Mr. Sullivan as honest, as 6 competent, if we were sitting here in 1998? 7 MS. VIRAG: Sam Ranzilla? 8 MR. RANZILLA: I'm not prepared to answer 9 that question, Joe. 10 (Laughter.) 11 MR. RANZILLA: Hypothetical. 12 I'd like to address two things. One is 13 the concept of principal evidence and, secondly, the 14 proposed auditing standard on the use of the work of 15 others. 16 With respect to principal evidence, I 17 support the elimination of those words. My own 18 belief is the elimination of those words doesn't do 19 much, if anything; and if they were driving behavior 20 that wasn't appropriate, which I think at best is 21 anecdotal evidence, then I think that's fine. 22 There's been a notion of principal</p>

<p style="text-align: right;">Page 142</p> <p>1 evidence in the auditing standards long before 2 Auditing Standard No. 2; and it will continue to be 3 one of the implicit standards in an auditor's ability 4 to sign an auditor's report that says in my 5 opinion -- not in the opinion of management, and not 6 in the opinion of the internal auditors -- but in my 7 opinion, these financial statements are blah, blah, 8 blah, or this internal control is up or down. 9 So while I support the notion of removing 10 the words "principal evidence," I don't think it's 11 changed the auditor's responsibility with respect to 12 its ultimate objective. 13 With respect to the use of the work of 14 others, I don't support the issuance of standard 15 number 6, if we're going down that path. I think 16 that the board has made the appropriate changes 17 through auditing standard number 5. If there were 18 impediments to the issues that might have been 19 leading to less than optimal use of others in an 20 internal control audit, I think those have been 21 amended; and that coupled with existing auditing 22 standard number 65, I think is, in my belief, exactly</p>	<p style="text-align: right;">Page 144</p> <p>1 conclusion. You know -- at the end of the day I 2 don't have a problem if people want to use internal 3 audit. And pursuant to what John said, it is -- to 4 the internal audit department, because we know we 5 have some that are very good and some that are really 6 lousy and some that are somewhere in between. 7 That's where I think the SAS 65 on use of 8 specialists, as it exists, is already very good. It 9 talks about those situations and how you have to deal 10 with it. I don't see this as being an improvement on 11 that. I don't know why you do it. That's why I 12 agree with Sam. 13 But then I would come back and say in the 14 report, if you're using someone else to do part of 15 your work for you, I would like to know that as an 16 investor. Just as we require the auditors to tell us 17 if they're relying on work of others on the audits of 18 the numbers in the balance sheet or income statement, 19 and we note that, I think they should note that here, 20 too, and give us a heads-up. 21 I can only think of one reason you 22 wouldn't be able to tell us and that's not a good</p>
<p style="text-align: right;">Page 143</p> <p>1 where we want to be with respect to the integrated 2 audit. 3 So I do not support the proposed standard. 4 MS. VIRAG: Lynn Turner? 5 MR. TURNER: Once again, I'd agree with 6 those last comments of Sam. 7 I think the current standard that we've 8 got up there is fine. If you decide to go to in the 9 direction that you're headed, then I think you got to 10 couple it with being transparent to investors. I 11 think you need to first off clarify in the standard 12 that takes any of the burden off the auditor to 13 ensure they gain sufficient evidence that they 14 themselves have enough that they can conclude, and 15 that we're not going to hear cop-outs later on about 16 "well, that was done by the internal auditors" or 17 anything like that. 18 So I think you need to make it very clear. 19 I would do that, once again, by going and laying the 20 principles out right up front, in bullet form, and 21 note that one the principles is you have to get 22 enough evidence from the testing to form your own</p>	<p style="text-align: right;">Page 145</p> <p>1 reason to leave it out in the first place. 2 MS. VIRAG: Damon Silvers? 3 MR. SILVERS: I think there's a principle 4 here that the board ought to follow in relationship 5 to these issues, which is the principle of the 6 integrated audit. That the degree of reliance which 7 an auditor can place on the work of others in the 8 control audit ought to be conceptually the same 9 degree of reliance an auditor is allowed to place on 10 the work of others in the financial statement audit. 11 I don't know the terms of art that get you 12 there, but I think that's the principle that you 13 ought to be following. 14 I think that the creation of a separate 15 standard on the work of others would suggest 16 something else is going on; and so I don't believe 17 that that's an appropriate thing to do. 18 And I believe, by the way, that this is an 19 area where a great deal of danger lies. I would call 20 the board's attention to the words of the statute, 21 section 404 which -- an attestation as to the truth 22 of the assessment by the independent auditor.</p>

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<p>1 That points at what's really going on</p> <p>2 which is the independent auditor is slapping their</p> <p>3 stationery on management's assessment. At that</p> <p>4 point, somebody is violating the statute.</p> <p>5 And the -- more -- from law to real life,</p> <p>6 right? -- the risks that everyone involved in</p> <p>7 creating such a situation would bring upon themselves</p> <p>8 would be very dramatic, in relationship to the day</p> <p>9 when a large company would explode as the result of</p> <p>10 such a thing.</p> <p>11 I can guarantee you if that were to</p> <p>12 happen, and if somebody cab walk into a courtroom</p> <p>13 with a defense lawyer and point to the standard, and</p> <p>14 state, "the standard allowed me to rely on the</p> <p>15 preparer; I should be able to walk out of this</p> <p>16 courtroom free of liability and not in handcuffs," I</p> <p>17 can guarantee you the judge will say that standard is</p> <p>18 inconsistent with the statute and whatever you say</p> <p>19 those words mean, they don't mean that.</p> <p>20 It would be far better to get the words</p> <p>21 right in the first place.</p> <p>22 MS. VIRAG: If there's no other thoughts</p>	<p>1 that management develops its resources to accomplish</p> <p>2 this work.</p> <p>3 I am really confused. I know Mark</p> <p>4 mentioned earlier he's reluctant to have people from</p> <p>5 the PCAOB comment on this; but I would actually like</p> <p>6 some helpful comments in this area about the degree</p> <p>7 to which we're discussing this.</p> <p>8 I mean when we audit, for example,</p> <p>9 inventory, is there really a question about your</p> <p>10 public company auditor being able to rely on the work</p> <p>11 of others in cycle discounts? Or are we going to</p> <p>12 drive that level of work up to an outside vendor?</p> <p>13 So I have perhaps some misunderstanding of</p> <p>14 this issue, and understanding the degree, but some of</p> <p>15 this discussion seems a little bit contrived as a</p> <p>16 real world problem, at least to me.</p> <p>17 MR. RAY: Let me comment just very</p> <p>18 narrowly. I think your example was a good one. The</p> <p>19 cycle account example, as I read the standards</p> <p>20 currently, my reading is if the cycle accounts are</p> <p>21 done periodically throughout the year by internal</p> <p>22 auditors, the independent auditor may look at that</p>
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<p>1 on that -- Marty Singer?</p> <p>2 MR. SINGER: I might have some confusion</p> <p>3 about this point. When I read it, I was a little</p> <p>4 confused. I'm a little confused by the discussion.</p> <p>5 When we talk about the work of others, we</p> <p>6 had a discussion, I think two meetings ago, about</p> <p>7 whether there ought to be different standards for the</p> <p>8 work of specialists who were internal versus</p> <p>9 external. And it seemed that there was a potential</p> <p>10 of having some unnecessary barrier to having work</p> <p>11 done by, let's say, an internal tax specialist.</p> <p>12 What I'm unclear on is, is there actually</p> <p>13 an objection here to having an outside audit firm</p> <p>14 rely on the work of others in the area of cycle</p> <p>15 counts of inventory, tax, or other preparation?</p> <p>16 And, indeed, isn't one of the goals of</p> <p>17 Sarbanes-Oxley to impose a standard of excellence on</p> <p>18 your internal finance capabilities, so that more of</p> <p>19 this work is done internally?</p> <p>20 It may be that there is liability in</p> <p>21 having an outside auditor rely on some of that work.</p> <p>22 On the other hand, it is a reasonable expectation</p>	<p>1 work and evaluate it and decide whether they're going</p> <p>2 to use that work as it relates to the nature, time,</p> <p>3 and extent of work they need to do with regard to the</p> <p>4 existence of inventory.</p> <p>5 I think if that work was done by somebody</p> <p>6 else, it's unclear as to whether the auditor would be</p> <p>7 able to use that work.</p> <p>8 But I'd certainly welcome other views on</p> <p>9 that point under the existing standards again.</p> <p>10 MR. OMTVEDT: May I offer you a</p> <p>11 perspective on that and stay with your cycle count</p> <p>12 example? At the end of the day, as a starting point,</p> <p>13 the cycle counting is part of our management controls</p> <p>14 just to be comfortable that our inventory systems are</p> <p>15 working.</p> <p>16 I think one needs to differentiate between</p> <p>17 what's happening in the normal course of day-to-day</p> <p>18 activities versus perhaps a situation where we have</p> <p>19 the internal audit group going in to an audit on a</p> <p>20 management location to test the quality of the</p> <p>21 controls.</p> <p>22 I think you really have three tiers here.</p>

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<p>1 The day-to-day activity, the -- separate to John's 2 point earlier -- the independent assessment of those 3 controls by a qualified internal audit group, and 4 then whether or not the external auditors can place 5 reliance on the work of the auditors.</p> <p>6 I hope that helps.</p> <p>7 MS. VIRAG: Lynn Turner, I think you're 8 next.</p> <p>9 MR. TURNER: The question that Martin 10 poses here, though, is an interesting question. If 11 you look at the companies that disclose material 12 weaknesses after their first implementation of S-OX 13 404, including the external auditor requirement, 14 about 95 percent of management certified that the 15 controls were effective, right up to the last interim 16 period before a control weakness was disclosed to the 17 investors.</p> <p>18 And so the question becomes, since that's 19 almost the entire population, just 5 percent short, 20 would you under this standard be permitted to rely 21 upon that 95 percent of management that had it wrong 22 right up to the very last quarter? And why would any</p>	<p>1 Sarbanes-Oxley, but to run its business in an 2 efficient, effective manner.</p> <p>3 In looking at the proposed standard, it 4 doesn't appear to me like the PCAOB is saying that 5 the auditor doesn't have any responsibility here; 6 they just take somebody else's work. I'm reading to 7 it say that the auditor is, in fact, responsible no 8 matter who does the work; and they don't share this 9 responsibility.</p> <p>10 And if you look at -- I forget the section 11 it is -- section 9, the auditor must obtain 12 sufficient, competent evidence.</p> <p>13 If you go to 10-B, the auditor must 14 evaluate the competence and objectivity of the 15 individuals. It lays out risk factors considering 16 the use of this other work.</p> <p>17 If you go to paragraph 15, it appears 18 really to be saying that largely we expect you, if 19 you're using work, to be using the internal auditor's 20 work.</p> <p>21 So I guess I viewed this as a reasonable 22 way to approach this and provide a framework to the</p>
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<p>1 auditor in their right mind be using that work by the 2 management team, because presumably they were doing 3 some testing or whatever to get to the 4 certifications? And it absolutely fell miserably.</p> <p>5 Why would you under any circumstance 6 permit the auditors to rely upon it? That's why it 7 comes back to what John so appropriately said, of it 8 needs to be focused on an appropriately constructed 9 and staffed internal audit team. And as Sam said, go 10 back to the requirements that already exist or, are 11 not always working, but seemed to have move us along 12 out of the current SAS.</p> <p>13 MS. VIRAG: Jeff Steinhoff?</p> <p>14 MR. STEINHOFF: Of course, I guess I see 15 this as part of the overall process one has for 16 assessing risk. So I think the auditor would find 17 out what management does on a day-to-day basis to 18 assure itself it's running its business in the proper 19 manner, as I mentioned prior to lunch, I view the 20 internal control as management's responsibility, as 21 to management's advantage that it does this well. 22 Not to be compliant per se with</p>	<p>1 auditor to consider a range of other work that may or 2 may not be done. If the auditor went in and found 3 that management did not have an internal audit 4 function, management was not reviewing its own 5 controls, or doing its cycle accounts, the auditor 6 would consider the control environment not to be very 7 good.</p> <p>8 If the auditor found they were doing this, 9 they would certainly factor that into what testing 10 they may be doing. They may elect to observe a cycle 11 account or two; but I don't see in the standard that 12 it's really even implying that the auditor could just 13 simply say -- you know -- Marty's having these cycle 14 accounts, therefore I can rely on that.</p> <p>15 I think the standard says I have to have 16 competent evidence at the end, and I can go about 17 having competent evidence in a variety of ways; and 18 it's not saying I have to go count every cycle or 19 inventory every item. But I have to use my 20 professional judgment in considering risk in making 21 that determination. 22 So that's -- I think this is really a</p>

<p>Page 154</p> <p>1 reasonable approach to doing it; but it does not take 2 the responsibility off the auditors or shareholders 3 at all. At the end of the day. 4 MS. VIRAG: Marty Singer? 5 MR. SINGER: I agree with those last 6 comments. I do want to comment on Lynn's statistics. 7 We had this discussion before. It is not surprising 8 after the implementation of Sarbanes-Oxley and 404, 9 there were disagreements between management and 10 outside auditors on what was acceptable. The game 11 changed. There were new definitions of process. So 12 these statistics are somewhat artifactual. 13 The other issue is, of course, a lot of 14 these discrepancies revolved around the process 15 associated with smaller companies, an issue this 16 group is less and less sympathetic to, as you want to 17 get rid of any sort of departure from one size fits 18 all. 19 But the issue, of course, for smaller 20 companies was the issue of materiality, another issue 21 we discussed. I was talking to Vince earlier, and he 22 mentioned this as an important issue. You have small</p>	<p>Page 156</p> <p>1 about perhaps the paragraph on -- paragraph 9 which 2 is sufficient competent evidential matter. Marty, 3 your point, Sam raised, if standard number 6 is going 4 to stay, to bring these concepts -- and Lynn brought 5 this up -- I just thought it might be helpful to know 6 what it says. It might help this conversation a 7 little bit. 8 It basically says for assertions related 9 to material financial statement, where a risk of 10 material misstatement or degree of sub-activity 11 involved in the evaluation of audit evidence is high, 12 the auditor should perform sufficient procedures to 13 fulfill the responsibilities described in earlier 14 issuer opinion. In determining these procedures the 15 auditor gives consideration to results of work, 16 either test of controls or substantive tests 17 performed by internal auditors, and those particular 18 assertions, however, for such assertions, the 19 conversion of internal work cannot alone reduce audit 20 risk to an acceptable level to eliminate the 21 necessity to perform tests of those assertions by the 22 auditor.</p>
<p>Page 155</p> <p>1 companies with GAAP earnings near zero and, for 2 example, in our case, we had a \$50 million antenna 3 business, \$2 million inventory. \$50,000 of 4 discrepancy was a material weakness, because it 5 wasn't mentioned against the asset that was important 6 to shareholders, it was measured against GAAP. Okay? 7 If we are losing a whole lot of money it would have 8 been immaterial. 9 That was one of the delights of this whole 10 process. There were definitions of material 11 deficiencies or weaknesses that I think were somewhat 12 artifactual; but again, I agree with these last 13 comments. It doesn't suggest at all that the auditor 14 abdicates responsibility. What it suggests is that 15 you have learned competence on the part of management 16 in these areas, not learned dependence. 17 And management has to be for improving its 18 processes. Here it is like cycle counting and other 19 audit practices. 20 MS. VIRAG: Vin Colman? 21 MR. COLMAN: You know, I just thought it 22 has been mentioned a couple of times in the confusion</p>	<p>Page 157</p> <p>1 I think this is right on point to what is 2 missing -- performance -- in AS-6 to clarify it. It 3 is very subtle in paragraph 9, where you need to 4 obviously have sufficient evidential matter to issue 5 your opinion. This perhaps would clarify. 6 I think this is the point at when people 7 are simply saying could you go back to what was in 8 the old standards, I think that's what they mean by 9 it. It would be a really helpful clarification. 10 MS. VIRAG: Damon Silvers? 11 MR. SILVERS: I think the issue facing the 12 board is the question, not of whether or not we want 13 to build internal competence within issuers; I think 14 we all do. Marty's question is yes, we want 15 competence here and want technical strength. But the 16 dilemma that faces the board what is to do about 17 essentially the fact that no matter how good you are 18 as an internal auditor, you are not the independent 19 auditor. 20 And how to guide the independent auditor 21 in such a way that they can both make use of 22 information that's generated from internal expertise</p>

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<p>1 without confusing this question as to who is 2 independent and where the ultimate responsibility 3 lies. 4 And that's a challenging task. It is why 5 in my earlier comment, I said you need to keep your 6 eye on the notion that there's a kind of -- there 7 needs to be an integrated audit standard here, guided 8 by the audit profession's sort of historical sense of 9 how to do this in areas other than internal controls. 10 I think that's the right way to think about it. I 11 don't know what the words are that you need to write 12 to implement that. 13 On the other hand, I think we need to be 14 cautious about sort of assuming, for example, that 15 all kinds of terrible things are happening around 16 this -- different. For example, if you're dealing 17 with companies that are not profitable, losing a lot 18 of money, then you can easily measure materiality in 19 that circumstance. 20 But my understanding is if it is a 21 break-even kind of situation, that the materiality 22 standards in terms of the company's finances, of what</p>	<p>1 either the financial statements or the system of 2 internal control. 3 I think you've confused the need to 4 increase the competence of the persons preparing the 5 financial statements, the competence of the persons 6 being part of the internal control system, and the 7 role that the auditor has to play in their audit of 8 either one of those in gathering evidence. 9 MS. VIRAG: Bob Tarola? 10 MR. TAROLA: Thank you, Sharon. 11 My concern here is the slippery slope 12 concern. In my experience, anyway, I found that I 13 generally got burned when I relied on someone else 14 and didn't -- because they were a known expert, and 15 because of that, I didn't do as much diligence as I 16 might otherwise have. 17 I think it is proposed for external 18 auditors to rely on the expertise of others, either 19 inside the company or experts that the company 20 engages, such as actuaries; but I think there has to 21 be an air of caution. I think the words in the 22 standards have that caution. So I didn't in my own</p>
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<p>1 constitutes a material event, if I have a company 2 with \$200 million in revenue and it is break-even, 3 profitability zero, that does not mean each coffee 4 spoon is a material event. You look to other 5 measures of materiality in that circumstance. 6 And I think that's sort of the way it is. 7 Maybe somebody has the misfortune of dealing with 8 people who don't know the standards. But that's how 9 it is. And that kind of common sense stuff is the 10 way this ought to be guided. 11 MS. VIRAG: Ed Trott. 12 MR. TROTT: Marty, let me say I think 13 respectfully -- whatever that word is -- I think you 14 are confused. 15 The fact that I hire a very competent tax 16 person or a very competent inventory person who might 17 be able to do a great job in preparing a financial 18 statement or might be able to do a great job of 19 having an internal control system that includes cycle 20 count is one thing. But using the work of others I 21 believe is -- the work of others in helping the 22 auditor gather the evidence to be able to opine on</p>	<p>1 thinking think it was a problem. I thought it was 2 the right balance. 3 But I think I would like to see the 4 diligence continue that the auditor as well as the 5 financial statement preparer and certifier have -- do 6 enough due diligence on the work of other parties to 7 take responsibility for it. 8 MS. VIRAG: Arnie Hanish? 9 MR. HANISH: I guess I'm a little confused 10 in listening to the dialogue. As I read the proposed 11 standard, personally I'm rather comfortable with the 12 way it is stated. 13 So I would support the board in its 14 progress to using the work of others, especially as 15 it relates to the opportunity to utilize the work of 16 others to reduce the degree of testing as it relates 17 to internal control testing by the auditors. And I 18 think this is clearly one way where we can see some 19 efficiencies and hopefully more effectiveness in the 20 internal control process. 21 So I guess I'm a little confused as to 22 where the tone and tenor of the discussion is headed.</p>

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<p>1 That's -- whether or not those of you that are sort 2 of articulating some of the points are suggesting 3 that we should throw this out? Or maybe I'm just 4 misunderstanding the direction that is being taken 5 here.</p> <p>6 But I certainly support it and would hope 7 we would embrace it as a step forward to be more 8 efficient and effective at what we do in conducting 9 the audits of internal control.</p> <p>10 MS. VIRAG: Randy Fletchall?</p> <p>11 MR. FLETCHALL: To that point, Arnie, I 12 thought Ed said it very well, in terms of describing 13 the difference between the preparer and auditor. I 14 think the proposed changes, proposed standard to 15 replace AS-2 does as said remove -- if there were 16 barriers before, if there was a mindset one had of 17 using the works of an internal qualified audit 18 department, I applaud those changes. It is good to 19 get rid of anything like that.</p> <p>20 Where there is confusion, though, in the 21 new proposed standard on using the work of others, 22 this seeking out relevant activities of management</p>	<p>1 all of the five topics we have selected for 2 discussion. Thank you. Do you want to slip one in 3 on this topic? Joe Kellas?</p> <p>4 MR. KELLAS: I was sort of waiting for the 5 discussion on barriers to be ended and then take the 6 final question. I'm not sure if you're wrapping up 7 the barriers.</p> <p>8 MS. VIRAG: I was going to wrap it all up. 9 I thought we got through both of those. We would 10 love to hear from you.</p> <p>11 MR. KELLAS: One point on integration, 12 maybe this is why not much has been said on it. It 13 is not easy to answer on the back of the proposed 14 draft because it depends on what is in the other 15 standards in relation to risk assessment and so on.</p> <p>16 When I read the draft standard, I noticed 17 references to risk of material weaknesses; and so the 18 language of risk assessment has been transplanted 19 from assessing the risk of material misstatement to 20 assessing the risk of material weakness.</p> <p>21 Now, in simple terms, a material weakness 22 is a state of affairs where the risk of material</p>
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<p>1 would suggest there's something there besides the 2 competence and objectivity and controls they have in 3 place to prepare financial statements, and suggests 4 there's something else out there.</p> <p>5 Again we're chasing this Holy Grail. You 6 would have considered those other things in making 7 risk assessments to start with. I think it is 8 promising there's something more there that we could 9 take and use. Now in a bank situation you might have 10 something -- you might have a credit review 11 department.</p> <p>12 But I think it promises maybe there's 13 something else out there that management is doing 14 that would constitute ^ designation alter ^ audit 15 evidence, and I think as we look -- we are having 16 trouble finding where that would be. That's where we 17 are comfortable with the existing standard on using 18 the work of others but the changes to AS-2 that 19 remove any barriers that might have been in existence 20 with respect to internal control.</p> <p>21 MS. VIRAG: Unless there's more comments, 22 I think this will wrap up the subject; and actually</p>	<p>1 misstatement is too high to be acceptable.</p> <p>2 So you now are talking about risks of a 3 risk. And I just wondered how that integrates with 4 what you have on the other side of the audit about 5 risk assessments?</p> <p>6 So that's where I would ask myself: Is 7 there a true integration of the two standards; and is 8 it a complication to be starting to talk about risks 9 of material weakness as opposed to risks of material 10 misstatement?</p> <p>11 MS. VIRAG: Okay. At this time I would 12 like to open it up for any other discussion points on 13 auditing or on the proposals, analysis. We didn't 14 scope the subjects, but if you have other comments 15 you would like to make at this time please feel free. 16 Rebecca McEnally?</p> <p>17 MS. McENALLY: Thank you. Just s very 18 brief and a very general comment. A small proposal 19 to think about here.</p> <p>20 The discussion today has been quite 21 interesting. I think it has been very helpful in 22 identifying potential confusions, areas where</p>

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<p>1 misunderstanding could occur, with resulting audits 2 that are less than we'd like them to be, and also 3 difficulties in auditors working with managers at 4 companies. 5 But I want to raise something slightly 6 different. Lynn Turner raised an issue that I think 7 characterizes a lot of issues in this particular 8 area. 9 The audit of internal controls has been 10 around forever. When I was teaching auditing decades 11 ago -- not quite that long -- it was an issue. It 12 was in the text. It was something we taught. Yet in 13 practice, somehow, it was not at the top of the list 14 in most audits. 15 What Lynn was really saying, I think -- 16 and he will correct me if I'm wrong -- is that in the 17 area, for example, of top-down, risk-based audits of 18 controls, we haven't made all the progress we would 19 like. We've been doing it for 20 years, but we're 20 still seeing problems. 21 Perhaps -- and I hope it is certainly true 22 -- we are seeing fewer problems than we would have</p>	<p>1 fill in some more silently, please. 2 Was it a matter of competence? Was it a 3 matter of experience? Were the incentives all wrong? 4 Just exactly what was going wrong here? 5 Because until we approach that problem -- 6 which is really basically an issue -- we're not going 7 to know what we need to do to ultimately improve our 8 standards and to make certain these things aren't 9 happening, or at least to provide as much assurance 10 as we can. We can't get to zero. 11 You have within the PCAOB I think the 12 capability to do it; but it's my understanding that 13 it's not going quite that fast. 14 Let me be quick to say before anybody gets 15 excited here, I wouldn't -- I know what's going 16 through the minds -- I would not want to see this as 17 part of a criminal or civil proceeding. That's not 18 the proper place. What we want is a learning process 19 and, therefore, a revision to the work that we're 20 doing, an improvement of the process and not 21 primarily a fault-finding process. 22 So I would encourage the -- those in a</p>
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<p>1 seen six years ago. I do fervently believe that. 2 But there are still problems. 3 I see this as an opportunity for us. The 4 opportunity I see is that the PCAOB in its normal 5 day-to-day operations and functioning has a vast 6 amount of data. It has a lot of insight into what is 7 going on in the audits; and it has an opportunity to 8 move beyond the analyses that it is currently tasked 9 with doing. 10 I would like to see these analyses where 11 there are serious problems emerging, serious 12 failures, certainly serious failures, but other 13 problems as well, carried beyond the point of whether 14 an auditor failed to pick up on a problem in revenue 15 reporting, and whether that got corrected promptly 16 and whether that problem appeared later. 17 I would rather see that, in addition to 18 that, the whole process gets carried one more level, 19 one more step. 20 Why did the auditor fail to pick up? 21 Was -- and I -- at this point we get into touchy 22 territory. I'll say a couple of words; you please</p>	<p>1 position of authority to give some consideration to 2 it. 3 Thank you. 4 MS. VIRAG: Cindy Richson? 5 MS. RICHSON: I have a question that is a 6 follow-up to what several SAG meetings ago where the 7 topic of limitation of liability provisions for 8 auditors was discussed. This is actually a question 9 I would like John White or Conrad Hewitt to address 10 if they wouldn't mind. 11 I have heard and seen press accounts and 12 references to speeches that the SEC was considering 13 incorporating limitation of liability limitations 14 into AS-2. I wonder if that's true. I would like to 15 say for the record if that is true, which I hope it 16 is not, that would be a significant detriment to the 17 investing public and would significantly take away 18 very important checks and balance in our existing 19 system. 20 MR. HEWITT: Thank you for the question. 21 I believe the SEC probably will not have anything 22 like you described in the past. The SEC does</p>

<p style="text-align: right;">Page 170</p> <p>1 exercise safe harbors in some of their rules such as 2 the designated financial expert, which I was for 3 three public companies. I was glad to see the safe 4 harbor, as a person, that my liability would not 5 exceed that of any other board member. I think 6 that's the type of thing that should be exercised by 7 the SEC. 8 We don't have any other plans to do things 9 like that in AS-5. 10 MS. VIRAG: Jeff Carcello? 11 MR. CARCELLO: These are from the auditing 12 standards committee of the auditing section of the 13 IAAA. They forwarded me their comment letter and 14 asked me to consider if there's anything I want to 15 incorporate into my written comments. 16 One deals with a change in consideration 17 of weaknesses; and the AS-2 had language "more than 18 remote" and now the language has changed in the new 19 standard to "reasonable possibility." 20 And the board may want to consider -- 21 there is actually research on this -- as to how 22 auditors operationalize these terms. And you may</p>	<p style="text-align: right;">Page 172</p> <p>1 clear in the exposure draft that pertains to 2 companies where the listing standards would require 3 an independent audit committee. 4 The question then I guess is even if 5 you're not required to have an independent audit 6 committee, the COSO framework when it talks about 7 control environment, which is typically the framework 8 that's going to be used, strongly emphasizes an 9 independent board, an independent audit committee as 10 a major feature of a control environment that's 11 effective. 12 And maybe more importantly than that even, 13 there's extensive research that finds an overwhelming 14 direct relationship between independent directors and 15 a lower incidence of both fraud and misstatements. I 16 refer you to work by Patty LaChow in 1996, Mark 17 Beasley in 1996, and David Farber in 2005. 18 MS. VIRAG: Damon Silvers? 19 MR. SILVERS: You know, to Cindy Richson's 20 question and ^ Con's response, I want to add 21 something that is very important here. 22 Everybody knows and it is appropriate that</p>
<p style="text-align: right;">Page 171</p> <p>1 want to go back and look at a 1994 paper by Amir 2 Hackenback and Mark Nelson. And the median 3 probability that audit managers use for the term 4 "remote" is 10 percent and the median probability 5 that audit managers use for the term "reasonable 6 possibility" is 60 percent. 7 That's a really big difference. Is that, 8 in fact, what the board really wants to put in place 9 if, in fact, audit managers are operationalizing it 10 in that manner? 11 Now, they don't have to. One of the 12 questions you might want to think about is, is it 13 really appropriate to use the FAS 5 framework in the 14 standard? 15 I know the first SAG meeting I came to I 16 referenced that framework. I think somebody had a 17 comment, something to the effect that it was garbage. 18 And so you might want to think about whether, in 19 fact, that's appropriate. 20 The second comment relates to a strong 21 indicator of a material weakness being a lack of an 22 independent audit committee. And you make it very</p>	<p style="text-align: right;">Page 173</p> <p>1 the SEC and the PCAOB interact a great deal on the 2 issues that they mutually face. And that that occurs 3 at the staff level, that occurs at the board level. 4 That's fit and proper and healthy. 5 However, there is, I think, a constant 6 danger given just the way the Sarbanes-Oxley Act is 7 structured and the formal relationships that exist 8 between the commission and board, there's a constant 9 danger of inadvertently people at the Commission 10 saying or doing things that might be perceived as 11 undermining the autonomy and independence of the 12 PCAOB. 13 I think from the investing public's 14 perspective, this is exactly what we don't want to 15 see. It doesn't do anyone any good when that 16 happens. And it is not a question necessarily even 17 of the reality but of the perception, what people 18 hear, what people say. 19 I have been in public quite supportive of 20 the outcomes that have occurred in the 404 area from 21 both the PCAOB and the Commission as a general 22 matter. And I hope that -- and I say that to sort of</p>

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<p>1 emphasize the respect I have for the Commission on 2 many levels -- but I would give some advice to the 3 folks from the Commission who are here which is keep 4 in mind how important it is to reinforce the 5 independence of this body here and how much 6 responsibility rests on the Commission and its staff 7 in relation to doing that, given the way the two 8 institutions are structured and linked.</p> <p>9 MS. VIRAG: Lynn Turner.</p> <p>10 MR. TURNER: A broader overarching issue 11 not only with internal control but the fraud stuff 12 we'll get into later on, does come back and begs the 13 question of, given what we're asking people to do in 14 this top down risk-based area -- especially without 15 additional guidance on certain procedures that people 16 should be looking at doing, as Craig mentioned 17 earlier -- is ultimately the question of do you have 18 people doing the work that are capable of doing it 19 and competent to do it?</p> <p>20 And when you talk about making these risk 21 assessments, you're talking about risk assessments 22 that usually people with the type of experience that</p>	<p>1 restatements coming through; and each one of those 2 have very serious consequences from a governance 3 perspective.</p> <p>4 How would you go in, for example, if 5 you -- the recent court case on Tyson -- here's 6 Tyson, a company that their board broke an agreement 7 with the Delaware court they earlier entered into; 8 they spring-loaded options, which the court has now 9 said is inappropriate and raises the currently 10 emerging issue for auditors given that current 11 decision on spring-loading.</p> <p>12 How could you even depend upon that board? 13 Given that, how could you even do an audit at Tyson 14 given that a number of those board members are still 15 sitting there at the top?</p> <p>16 And certainly those are all valid 17 questions that have popped up in many of these major 18 frauds. Yet this standard I don't think asks those 19 tough questions and gives a response to them.</p> <p>20 I think it is something you seriously have 21 to consider: How do we get from where we are at to 22 where we need to be on these?</p>
<p>Page 175</p> <p>1 are sitting around the table here are used to making. 2 Yet we know, 80 percent of the hours are still being 3 spent by people with zero to five, zero to six years 4 of experience. So while they're very sharp and 5 bright and talented people, there's no way that they 6 have the ability to turn around and go do those risk 7 assessments.</p> <p>8 I think you have to think about do you put 9 something in here about the fact that these risk 10 assessments have to be done at the partner level, 11 because they just can't be done by the people down 12 below. They don't have the experience. And history 13 has shown us that we're missing them.</p> <p>14 I still get back to, even notwithstanding 15 that are they going to pick up on them, we now have 16 an option scandal out there that's consumed well in 17 excess of 200 companies, and there's probably many 18 more out there that probably haven't disclosed it 19 yet. Yet the auditors didn't pick up on that at all; 20 and I suspect that it's because in part, whoever did 21 make the risk assessment on those audits assessed the 22 risk low. Yet we've seen some very, very significant</p>	<p>Page 177</p> <p>1 MS. VIRAG: I think with that we'll 2 conclude our discussion today on the board's internal 3 control proposals.</p> <p>4 Is there one more? I beg your pardon.</p> <p>5 MR. BECKER: To pick up on Lynn's point a 6 little bit. This standard -- it strikes me -- places 7 a huge premium on the capacity of the auditor, 8 whoever that happens to be, for risk assessment; and 9 I agree with Lynn's point that it does make a 10 difference as to who is assessing the risk.</p> <p>11 I also think, though, that there needs to 12 be built into this safeguards with respect to the 13 unapprehended risk, because it's the nature of humans 14 that there's not just not going to be -- able to 15 apprehend all the risks.</p> <p>16 I worry a little bit that there is too 17 much faith in the capacity of auditors to identify, 18 both at the outset and as an audit develops, all the 19 relevant risks, because we all get surprised. And we 20 get surprised with sort of startling frequency.</p> <p>21 What this standard seems to be, more than 22 anything else, is all the things that auditors don't</p>

<p style="text-align: right;">Page 178</p> <p>1 have to do compared with AS-2; and I just think it's 2 important to address the issue of the limits of 3 people's capacity to assess risk at the outset and 4 then what procedures are built into the audit as a 5 result.</p> <p>6 MS. VIRAG: Thank you. For the record, 7 that was David Becker speaking.</p> <p>8 At this time I'm going to pause longer to 9 see if anyone else would like to make another 10 thought?</p> <p>11 Dick Dietrich?</p> <p>12 MR. DIETRICH: I would like to reinforce 13 and amplify perhaps David's comments. There has been 14 research done trying to see how well calibrated 15 individuals are in assessing risk.</p> <p>16 Some of the experiments go along the 17 following way: Take an event that's going to occur 18 two weeks ahead, for example. What do you think the 19 high temperature is going to be two weeks from now? 20 Don't tell me the number. Tell me a range where you 21 think nine out of 10 times you'll be within that 22 number.</p>	<p style="text-align: right;">Page 180</p> <p>1 if they want to provide additional insight on these 2 or additional comments. The proposal period is open 3 until the end of the day.</p> <p>4 Thank you.</p> <p>5 We'll reconvene at 2:50.</p>
<p style="text-align: right;">Page 179</p> <p>1 And it turns out that we horribly 2 mis-estimate that tolerance.</p> <p>3 So we might say 90 percent of the time the 4 actual number is going to be within this range, and 5 it turns out to be 60 percent of the time. It gets 6 to this point of risk assessment.</p> <p>7 And it turns out that that doesn't -- that 8 does extend also to people with expertise. It takes 9 a tremendous amount of expertise -- I think, to 10 Lynn's point, it takes a considerable amount of 11 experience in estimating risk probabilities here.</p> <p>12 MS. VIRAG: Okay. So that concludes our 13 discussion on the board's internal control proposals.</p> <p>14 We appreciate everybody's participation. 15 I think that was extremely helpful for us. A lot of 16 great comments. We really appreciate that.</p> <p>17 As we mentioned in our briefing paper, the 18 transcript of this part of the meeting will be 19 included in the public comment file.</p> <p>20 Having said that, we also encourage all of 21 the SAG members, anyone in the audience or tuned in 22 to the webcast to submit comment letters to the board</p>	