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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

UNOFFICIAL TRANSCRIPT OF
MEETING OF COMMISSIONERS

April 4, 2007

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P R O C E E D I N G S

CHAIRMAN COX: Good morning. This is a meeting of the Securities and Exchange Commission under the Government in the Sunshine Act on April 4th, 2007.

Today the Commission is meeting to consider the progress of revisions to the auditing standard under Section 404 of the Sarbanes-Oxley Act and the coordination of those revisions with the new 404 guidance for management that was proposed by the Commission in December. This is a continuation of the process that the Commission and the Public Company Accounting Oversight Board began jointly in May 2006. The comment periods for both the new Management Guidance and the new 404 audit standard ended more than a month ago so now we're entering the home stretch of completing this important work. Today's discussion is intended to keep us on track to consider final adoption of our proposed Management Guidance by perhaps the end of May.

There is another reason it is vitally important that we meet today in particular because today is April 4th -- "4-04." Opportunities like this don't happen very often. It will be almost 6,000 years, for example, before we will have the same propitious conditions for considering amendments to our Form 8-K in the year 8K.

The order of events for today's meeting is as follows. We will hear first from Mark Olson, Chairman of the

1 Public Company Accounting Oversight Board, whom we have
2 invited to report on the Board's progress in revising the 404
3 audit standard and also on the status of our efforts to align
4 the 404 guidance for management and the 404 standard for
5 auditors.

6 Next, we will hear from Jeff Steinhoff, the
7 Managing Director for Financial Management and Assurance at
8 the U.S. Government Accountability Office. Mr. Steinhoff
9 will present the results of the GAO's investigation into the
10 implementation of Section 404 and its impact on smaller
11 public companies and also the GAO's recommendations for
12 improvements in the implementation of Section 404.

13 Finally, we will hear from the Commission's
14 professional staff, including the Office of the Chief
15 Accountant and the Division of Corporation Finance who will
16 provide a status report on our work with the PCAOB and make
17 recommendations for finalizing our respective proposals.

18 So let's begin by welcoming Chairman Mark Olson of
19 the Public Company Accounting Oversight Board.

20 Thank you, Mr. Chairman, for appearing before the
21 Commission today and for your leadership toward an improved
22 Section 404 process for companies of all sizes. The PCAOB
23 has been hard at work to replace the existing 404 audit
24 standard with a more risk-based top-down approach that is
25 scalable for companies of all sizes. And in that effort, the

1 Board under Chairman Olson's leadership has established a
2 solid working relationship with the SEC.

3 The Sarbanes-Oxley Act, which created the PCAOB,
4 has made our agencies partners in regulation. The SEC's
5 responsibility for supervision of the PCAOB requires that not
6 only the Board but also the Commission agree to and vote
7 for new auditing standards before they can become effective.
8 This requires a high level of coordination between the SEC
9 and the PCAOB. If a standard were approved by the Board but
10 not by the Commission, not only could it never take effect
11 but valuable time would be lost when the entire effort would
12 have to begin anew. Our intent is to have a new audit
13 standard and Management Guidance in place for use during the
14 2007 audit cycle, so there is no time to waste.

15 And for that reason, the Commission is particularly
16 appreciative, Mr. Chairman, of the collaborative approach
17 that you have taken to addressing this important priority.
18 As Chairman Barney Frank succinctly put it, our job as
19 regulators is to make the implementation of 404 "more
20 flexible" and to "cut back on some of the excessive rules and
21 regulations without compromising the core." You have shown a
22 keen appreciation of that objective and your leadership has
23 been and will continue to be vitally important to the success
24 of our joint efforts.

25 So, Chairman Olson, welcome.

1 CHAIRMAN OLSON: Thank you very much, Mr. Chairman.
2 It would have even been more appropriate if we could have
3 talked about 404 in the sunshine, but that didn't occur
4 today, but we came very close.

5 Chairman Cox, Commissioners Atkins, Campos, Casey
6 and Nazareth, thank you for the invitation to be with you
7 today to provide a sense of the analysis underway at the
8 PCAOB as we move to adopt a final standard for auditing
9 internal control over financial reporting.

10 This effort continues to be the Board's highest
11 priority and we are committed, just as the Commission is, to
12 the goal of completing the process of replacing Auditing
13 Standard Number 2 as soon as possible so that the new
14 standard will be in place for 2007 audits as you indicated.

15 In achieving that goal we are also committed to
16 working in partnership with the Commission throughout this
17 process. The PCAOB and the Commission also are partners more
18 broadly in our common mission to protect investors.

19 Every public company and every investor relies on
20 financial reporting. The importance of effective internal
21 control to reliable financial reporting cannot be understated
22 and Congress recognized this when it enacted Section 404, the
23 Sarbanes-Oxley Act.

24 As you are aware, in December of last year, the
25 PCAOB issued a set of proposals that would supersede the

1 Board's existing standard in auditing internal control, AS2.
2 The proposals were the culmination of two years of in-depth
3 efforts to understand the positive and negative aspects of
4 the implementation of Section 404.

5 We have worked hard to understand how the language
6 of AS2 has been understood and implemented by auditors. This
7 understanding has helped us identify changes that will
8 preserve the benefits of the standard and meet the statutory
9 objectives of Section 404 without resulting in the routine
10 performance of unnecessary audit procedures.

11 In addition to monitoring implementation the Board
12 has also made a concerted effort to obtain the views of all
13 stakeholders. Among other things, the Board participated
14 with the Commission in two round-table discussions with
15 representatives of issuers, auditors, investor groups and
16 others. The PCAOB Standing Advisory Group has focused
17 discussion on issues related to the standard over the course
18 of the last few years.

19 The Board also made a special effort to hear from
20 smaller registered public accounting firms through our forums
21 on auditing in the small business environment which continue
22 to be held around the country and sometimes include sessions
23 with smaller issuers.

24 In response to our proposal in December, we
25 received over 170 comment letters totaling some 1200 pages of

1 comments. These comments reflect a broad range of views. In
2 general they articulate considerable support for the
3 proposals as well as many helpful suggestions. Since the
4 first comments came in, our staff has been reviewing,
5 compiling and analyzing these comments. Indeed, my
6 colleagues and I on the Board have spent many hours reading
7 and thinking about the comments.

8 Owing to the thoughtful and constructive public
9 input we have received, our staff has already begun to
10 identify potential ways to revise the proposed standard. I
11 anticipate the Board will be able to make several
12 improvements including further streamlining the standard in
13 order to provide additional flexibility to promote
14 scalability, avoid unintended consequences and address other
15 valid concerns.

16 While the Board has been carefully considering and
17 describing the key issues, it is premature to say how the
18 Board will act on any particular issue nor to commit to any
19 course of action on behalf of the Board.

20 As with the Commission's process the PCAOB brings
21 the perspective of its five Board members to bear in
22 deliberating on and eventually voting on final board
23 standards. I can assure you, however, that we are open to
24 and are carefully considering all comments we have received
25 and that we are committed to adopting a standard that

1 fulfills the mandate of Section 404 without resulting in the
2 performance of unnecessary audit procedures.

3 Under the Sarbanes-Oxley Act, the Board's role is
4 to determine in the first instance what the auditing
5 standards should be based on -- should be based on its
6 knowledge and experience and in light of the statutory
7 criteria and to submit for Commission's approval standards
8 that reflect that judgment.

9 We understand our responsibility and value the
10 Commission's role in the process. Of course, in addition to
11 the oversight role, the Commission is charged with
12 implementing Section 404(a) of the Act which requires
13 management to assess the effectiveness of internal controls.
14 Because implementing Section 404 is a responsibility shared
15 by the SEC and the PCAOB our staffs regularly meet and the
16 Board members and I have met with the SEC commissioners to
17 further coordinate that work.

18 And may I say on behalf of the PCAOB that we have
19 been very appreciative of the accessibility of you, Mr.
20 Chairman, and also the members of the Commission in this
21 effort.

22 This collaboration is important and I am pleased to
23 describe for you today some of the issues that in light of
24 the comments received on the proposal are commanding
25 particular attention as we move toward adoption of a final

1 standard.

2 Let me highlight a few key areas where we received
3 substantial comment. We're looking closely at the comments
4 on the topic of the alignment between the Board's standard
5 and the SEC's Management Guidance and anticipate making some
6 changes to address this issue.

7 Management's assessment and the audit of internal
8 controls are distinct yet complementary steps in the Section
9 404 process of providing assurance to investors about the
10 reliability of companies' financial reporting. It is
11 important, therefore, that these steps be coordinated.

12 At the same time we must not lose sight of the fact
13 that management and the auditor have different perspectives
14 on the company's internal controls and the assessment and
15 audit have different objectives under Section 404.
16 Management is more directly involved with the daily
17 operations of the company and therefore works with the
18 company's controls on a constant basis. Therefore,
19 management's assessment of the effectiveness of the company's
20 internal control can and should reflect that familiarity.

21 The auditor's perspective, however, is quite
22 different. Like the financial statement audit, the audit of
23 internal controls is intended to provide investors with an
24 independent accountant's opinion formed on the basis of
25 procedures performed with appropriate professional skepticism

1 about whether the internal control is effective. The
2 standard must therefore establish a process through which an
3 independent auditor can form a sufficient basis for
4 expressing such an opinion.

5 Because of the fundamentally different roles
6 management and the independent auditors serve, the standard
7 the Board proposed in December would not require the auditor
8 to specifically evaluate management's assessment process.
9 Our intention was to recognize that management may perform
10 its assessment in a manner that may be different from the
11 process the auditor uses to reach an independent opinion.
12 Removal of the requirement to specifically evaluate
13 management's process together with the SEC's guidance to
14 management should see to it that the auditing standard does
15 not become the de facto guide to performing a management
16 assessment.

17 Just as management must prepare the financial
18 statements to be audited, management also must establish
19 internal controls over financial reporting within the company
20 and assess the effectiveness of its internal control which
21 the independent auditor must then audit.

22 While there was a close relationship between
23 management's and the auditor's work, this does not mean that
24 the audit should not consist of any different or additional
25 procedures other than what management has already performed

1 as part of its assessment.

2 By requiring an audit of internal control, the Act
3 clearly mandated an independent process of testing and
4 reporting on management's assessment of whether the company's
5 internal controls are effective.

6 We will carefully consider recommendations in this
7 area and continue to work with the Commission to make sure
8 that our final standard and the SEC's Management Guidance
9 appropriately complement each other.

10 The proposed standard includes a section on scaling
11 the audit for smaller, less complex companies. This section
12 incorporates discussion of both size and complexity. We
13 received many comments on this section from all affiliation
14 groups, auditors, issuers, investors, academics and others.

15 In general, most commenters were supportive of the
16 concept of scalability and the proposed standard's general
17 approach but made several recommendations for change.
18 Regarding the proposal's overall approach to scaling, a number
19 of commenters held the view that scaling is an implicit aspect
20 of the risk-based approach and specific tailoring approaches
21 are a natural extension of complexity as a risk factor.

22 Many commenters stated emphatically that this should
23 not be a stand-alone discussion that applies only to smaller
24 companies. Most commenters felt strongly that all audits
25 should be tailored based on the complexity of the company

1 even though the benefits of scaling are likely to be of great
2 benefit to smaller companies.

3 Regarding the practical implications of
4 scalability, there was general agreement among commenters that
5 the attributes listed were sufficient and that the tailoring
6 directions for auditors were adequate. A few commenters
7 believed that the standard did not provide sufficient relief
8 for smaller companies. These commenters suggested that the
9 standard should include more credit for controls testing
10 based on the work done as part of the financial statement
11 audit.

12 These are useful perspectives and the Board will
13 carefully evaluate the relevant provisions within the
14 proposed standard and consider whether additional changes
15 should be made to enhance the application of the scalability
16 concept for issuers of all sizes and complexity.

17 As I mentioned earlier, the Board's proposed
18 standard is written to provide a clear statement of the
19 principles that auditors should apply when performing an
20 audit of internal control. Those who rely on financial
21 statements should have some level of confidence that all
22 internal control audit opinions afford the same level of
23 assurance about the effectiveness of companies controls.

24 Accordingly the proposals provide a framework that
25 is designed to enable the auditor to obtain the reasonable

1 assurance necessary to support his or her opinion.

2 Some commenters, primarily auditors, pointed out
3 that the proposed standard includes a large number of
4 mandatory and presumptively mandatory requirements. Based on
5 documentation requirements and other PCAOB standards for each
6 of these requirements the auditor would need to document the
7 performance of the requirement which these commenters believe
8 would substantially increase the burden of the audit.

9 Other commenters referred to the documentation
10 required as one of the largest impediments to the auditor's
11 use of the work of others particularly in light of the
12 different nature of the SEC's Management Guidance.

13 Based on the comments received, the Board intends
14 to apply a critical eye to each of the "must" and "should"
15 requirements in the proposed standard to ensure that each of
16 them is necessary.

17 The Board is committed to issuing a standard that
18 affords auditors the flexibility they need to perform an
19 effective and efficient audit of internal control.

20 In conclusion, there are a number of other
21 significant areas such as use of cumulative knowledge, use of
22 the work of others, company-level controls, and risk
23 assessment where comments were thoughtful yet mixed. The
24 Board also is working through those issues.

25 As we move towards adopting a final standard, we

1 know that we must get the language of the standard calibrated
2 correctly and we intend to make that happen. What ultimately
3 will matter most, however, is what happens in the field. To
4 that end we plan to continue our dialogue with stakeholders
5 including our focused outreach to accounting firms of all
6 sizes but with a special emphasis for small firms. We also
7 plan to continue to use our inspection process to monitor
8 implementation of the new standard governing audit of
9 internal controls.

10 The PCAOB looks forward to continuing to coordinate
11 with the Commission in implementing Section 404 and other
12 aspects of Sarbanes-Oxley. We share the common objective,
13 investor protection, and are committed to implementing the
14 internal control provisions of the Act in a way that
15 maximizes their benefits to public companies and their
16 investors.

17 Thank you, again, for the opportunity to be here
18 today and we look forward to receiving the Commission's
19 input. Thank you.

20 CHAIRMAN COX: Thank you very much, Mr. Chairman,
21 for laying out some of the salient comments that we have
22 received in this process and also for giving us an up-to-date
23 assessment of where the PCAOB is in the process and where you
24 are focused.

25 As I mentioned during the introduction, you are

1 doing an outstanding job of making rationalizing 404
2 implementation the top priority for the PCAOB and I hope that
3 you will share with all the Board members and your
4 professional staff the deep appreciation that we have at the
5 Commission and throughout our professional organization the
6 deep appreciation that we have for the hard work, the energy,
7 the commitment that you have shown to getting this problem
8 solved. I think we are very close to getting this long
9 process completed in time for the 2007 audits and that will
10 be in great measure a tribute to you and your leadership. So
11 thank you once again.

12 CHAIRMAN OLSON: Well, thank you. I will accept
13 that on behalf of my colleagues and I will be sure to pass
14 the comments back to them. Thank you.

15 CHAIRMAN COX: Thank you very much.

16 Next, I'd like to welcome Jeff Steinhoff of the
17 Government Accountability Office. Mr. Steinhoff is the
18 Managing Director for Financial Management Assurance at the
19 U.S. Government Accountability Office and in this capacity,
20 he leads the GAO's largest audit unit with responsibility for
21 oversight of financial management and auditing issues across
22 the federal government. Among those responsibilities is the
23 annual audit of the SEC's own financial statements. In
24 addition, he represents the GAO on the PCAOB's Standing
25 Advisory Group.

1 Over the past several years, the GAO has undertaken
2 extensive work in studying the implementation of the
3 Sarbanes-Oxley Act. This work includes at least nine studies
4 and analyses of various aspects of Sarbanes-Oxley
5 implementation and it is focused in particular on the special
6 challenges of applying the Section 404 requirements to
7 smaller public companies.

8 Thus far, smaller public companies have not had to
9 comply with Section 404. But beginning next year, smaller
10 companies will be expected to come into compliance, and so it
11 is vitally important that we have a scalable approach that
12 works for them. Both the Commission and, as we've just heard,
13 the PCAOB are focused on this and we have been urged by
14 congressional leaders including House Financial
15 Services Committee Chairman Barney Frank,
16 Senate Small Business Committee Chairman John
17 Kerry, and House Small Business Committee Chair,
18 Nydia Velazquez -- to ensure that the Section 404
19 process is scalable for small businesses. And because these
20 committees have cited to us the importance of GAO's report on
21 the implementation of Section 404 for smaller companies, I am
22 especially pleased that Mr. Steinhoff can be here with us
23 today. We look forward to hearing from you about the GAO's
24 views on the implementation of Sarbanes-Oxley Act for smaller
25 public companies.

1 Mr. Steinhoff, welcome.

2 MR. STEINHOFF: Thank you so much. Chairman Cox,
3 members of the Commission, I am pleased to be here today to
4 discuss the Commission's proposed guidance for Section 404 of
5 Sarbanes-Oxley and the PCAOB's proposed revisions to Auditing
6 Standard Number 2.

7 Let me say at the outset we support the thrust of
8 the current proposals by the Commission and the PCAOB. Also
9 I support Chairman Olson's comments earlier today. These
10 proposals are responsive to the recommendations in our April
11 2006 report on the application of Sarbanes-Oxley Act to
12 smaller companies. In that report we recommended that the
13 Commission do three things. First, assess the sufficiency of
14 internal control guidance for smaller public companies.
15 Second, coordinate with the PCAOB to ensure consistency of
16 Section 404 auditing standards with any additional internal
17 control guidance for public companies. And, finally, if
18 further relief is deemed appropriate, to analyze the unique
19 characteristics of smaller companies and their investors to
20 ensure that the objectives of investor protection are met and
21 any relief provided is targeted and limited.

22 Investor protection is the heart of what we are
23 speaking about today and my remarks that follow today will
24 address not only smaller companies, but all companies because
25 we think that the application of standard 2 really provided

1 burdens to all companies.

2 Today I would like to briefly highlight three
3 issues that are critical to effective implementation of
4 Section 404 and we continue to strongly support Section 404
5 and the current proposals of the Commission and the PCAOB.

6 First, we strongly support the emphasis on using a
7 top-down risk-based approach in both management's evaluation
8 of internal control over financial reporting and in the audit
9 of management's evaluation. This is the approach we use at
10 GAO in our financial statement audits which provide an
11 opinion on internal control. We were doing this prior to
12 Sarbanes-Oxley and that includes the consolidated financial
13 statements of the U.S. Government, the IRS, the Bureau of
14 Public Debt, the FDIC and, as Chairman Cox pointed out, the
15 SEC.

16 We urged a top-down risk-based approach
17 when the current Auditing Standard Number 2 was first
18 considered; and continue to strongly believe that this
19 approach if done properly -- and I emphasize done properly --
20 can maximize efficiency and effectiveness in the assessment
21 of internal control. Such an approach provides needed
22 flexibility for both management and auditors to make informed
23 decisions based on relative risk and cost benefit versus
24 having overly prescriptive one-size-fits-all requirements.

25 As the Commission and the PCAOB move in this

1 direction, the challenge will shift to the need to properly
2 implement this approach and to hold company management and
3 its auditors accountable for doing so.

4 Effective implementation of a top-down risk-based
5 approach requires the involvement of highly knowledgeable
6 senior management and audit professionals in order to make
7 sound judgments about the risk of internal financial
8 statement misstatement. Reaching the proper balance is
9 challenging but very achievable if the assessment is
10 approached with a goal of protecting the investor and with
11 the right amount of expertise and professional skepticism
12 going in.

13 If a top-down risk-based approach is not properly
14 implemented by company management and/or the auditors, its
15 effectiveness can be compromised. Therefore, if the proposed
16 changes are adopted it will be critical that the Commission
17 and the PCAOB closely monitor implementation.

18 In the case of the PCAOB, it has its inspection
19 program. Again, we're very supportive of risk based. We
20 think that's the only way to go, but it must be done in a
21 proper manner.

22 Second, the SEC and the PCAOB should continue to
23 emphasize management and audit responsibilities related to
24 fraud. Management's evaluation of financial reporting risks
25 should also consider the vulnerability of the entity to

1 fraudulent activity. The auditor's responsibility for
2 detecting and reporting fraud overlaps with his
3 responsibility for reporting on internal control over
4 financial reporting since effective internal control
5 generally serves as the first line of defense in preventing
6 and detecting fraud. These things are intertwined.

7 This is where professional skepticism becomes
8 paramount in the auditor's work. In assessing fraud risk,
9 auditors have to be inquisitive and vigilant. Auditors must
10 not just ask basic questions such as whether management has in
11 place a comprehensive fraud program that includes continuous
12 fraud oversight but they must dig deeper if things do not
13 look right or if there is a risk that they feel could result
14 in the financial statements being misstated whether caused by
15 error or fraud. Really, this whole thing is substance over
16 form. We need to look at the substance of what's going on
17 versus having a checklist mentality where every control is
18 reviewed, every control is documented. This has to be raised
19 up to where you are looking at risk and you're doing that for
20 the purpose of protecting the investor against those things
21 that are significant and those things that are important.

22 Third, coordination among regulators and standard
23 setters is very important. Continued coordination such as
24 today between the Commission and the PCAOB will be needed to
25 monitor implementation of Section 404 and to identify any

1 additional ways for achieving economical, effective and
2 efficient implementation.

3 It will be important that company management and
4 their auditors agree on what is expected and resolve any
5 implementation problems early on in the process. They need
6 to have a dialogue. Again, this shouldn't be viewed as just
7 a compliance approach on both sides, it should be focused and
8 tailored.

9 Also important is the need for the PCAOB to
10 continue to coordinate with other U.S. audit standard
11 setters, GAO and the AICPA and with international standard
12 setters on key issues such as the terminology and definitions
13 used to communicate internal control deficiencies.

14 At this time, all the U.S. standard setters are in
15 sync and have adopted consistent definitions of a material
16 weakness and a significant deficiency. Everyone will be best
17 served by having standard setters develop consistent core
18 auditing standards and where there are any differences
19 to articulate why there is a difference or a need in the
20 particular environment we're in.

21 Inconsistencies in core standards can increase
22 audit costs and lead to potential confusion among management,
23 users and auditors. In this context, we meet roughly three
24 times a year collectively. We had a meeting a couple of
25 weeks ago which David Walker hosted at the GAO and we're very

1 appreciative of the very open environment that the PCAOB has
2 fostered.

3 In closing, we support the efforts of the
4 Commission and the PCAOB to address Section 404
5 implementation issues. Public companies must be able to
6 strike an appropriate balance between costs and benefits
7 while at the same time achieving an appropriate level of
8 internal control and strong investor protection.

9 At the end of the day, public companies need to
10 have the right controls in the right place at the right time.
11 We view this as a basic management responsibility
12 irrespective of Section 404. At the same time, auditors have
13 an important role. They must be vigilant but practical which
14 a top-down risk-based approach provides for and must always
15 maintain independence and professional skepticism in doing
16 their work.

17 It will be very important that the Commission and
18 the PCAOB continue to reinforce the over-arching goal of
19 investor protection as well as the principles I have just
20 highlighted in order to achieve sensible, effective, and
21 responsible implementation of Section 404 and to ensure that
22 investors never again find themselves on the short end of an
23 Enron or a WorldCom.

24 Thank you again for inviting me and for permitting
25 GAO to participate in this forum.

1 CHAIRMAN COX: Thank you very much, Mr. Steinhoff,
2 not only for your excellent summary of the issues that we're
3 facing in scaling 404 for smaller companies but also for the
4 extensive and substantial amount of work that you and the GAO
5 have done in this area that provides the basis for your
6 presentation this morning. And that presentation I think is
7 an excellent scene setter for us to go to the final item on
8 our agenda which is to hear from our professional staff on
9 this same topic.

10 I'd like to begin now by recognize Conrad Hewitt,
11 the Chief Accountant of the Commission, and John White, the
12 Director of the Division of Corporation Finance and their
13 staff on the subjects of revising the 404 auditing standard
14 and also the progress that we have made in coordinating this
15 with our proposed Management Guidance.

16 And following the staff presentations and
17 discussion on each topic, we'll have the opportunity for
18 Commissioner questions and discussion. And following that
19 I'll ask whether the Commissioners support the staff's
20 approach on the particular topics.

21 So, if we may, let's begin with Conrad Hewitt, the
22 Commission's Chief Accountant.

23 MR. HEWITT: Thank you very much, Mr. Chairman.

24 Chairman Cox and members of the Commission, the
25 increased focus on companies' internal controls over

1 financial reporting, commonly known as ICFR, under Section
2 404 of the Sarbanes-Oxley Act in the Commission rules has
3 improved investors' confidence in our financial markets.
4 Overall, the public disclosures relating to ICFR have led
5 many issuers to establish and maintain more effective
6 internal controls which has resulted in financial reports
7 that are more reliable and transparent.

8 Although there clearly have been benefits, it is
9 also true that the cost to implement the related Commission
10 rules and the PCAOB auditing standard are significantly
11 greater than expected. Of particular concern are indications
12 of audit and compliance costs for small companies.

13 Concerns with Section 404, of course, are not new.
14 Efforts by the Commission and PCAOB have been underway for
15 sometime to meet the challenge of providing new guidance and
16 revisiting the prior requirements to better balance
17 implementation costs with the benefits.

18 Now I would like to turn to my colleague, John
19 White, the Director of the Division of Corporation Finance to
20 summarize some of those important efforts over the last year.

21 MR. WHITE: Thank you, Conrad.

22 And good morning. Chairman Cox, you mentioned and
23 actually the Commission's press release announcing today's
24 meeting also specifically noted that we are here today to
25 discuss the PCAOB's proposed new auditing standard under 404,

1 of course, but also in particular you noted and the press
2 release noted that we are here to discuss its coordination
3 with the Commission's proposed Management Guidance.

4 Now, as I think all of us know, the Commission and
5 the PCAOB have actually been working together now for
6 sometime to improve the implementation of Section 404.
7 Actually, a little less than a year ago many of us were here
8 in this very room, this very auditorium as the Commission and
9 the PCAOB jointly hosted a round table on second-year
10 experiences under Section 404.

11 That round table was followed a week later by press
12 releases in which the Commission and the PCAOB each announced
13 a series of steps that they planned to take to improve the
14 implementation of 404. The Commission specifically announced
15 that it expected to propose and then adopt guidance for
management
16 regarding its evaluation of internal control and that that
17 process would begin with a Concept Release to gather input.

18 And I believe, as all of us can see, those May 17
19 press releases were really important in previewing most of
20 the things that have actually happened in the last year in
21 the 404 arena. Of the Commission's four steps which were laid
22 out, the first was the Management Guidance which I have
23 described and the second was revisions to Auditing Standard 2.
24 The third was the SEC's oversight of the PCAOB inspection
25 process which was designed last year to focus on the efficiency

1 of Section 404 implementation and the fourth step was the
2 extension of the compliance deadlines for non-accelerated
3 filers which was finalized in December.

4 Now, the last two steps, the inspection process and
5 the extension of the deadlines, are not the focus of today's
6 meeting, but I think it is important to realize that all four
7 of these steps are coordinated components in a
8 comprehensive project that has been undertaken by the PCAOB
9 and the Commission and our respective staffs.

10 And I think you all appreciate that this has very
11 much been a priority of all of us here at the table during
12 the last year as I know it has been a priority of all of you
13 for the last year.

14 So getting back to the steps laid out last May, the
15 first step, of course, was to move forward on management
16 guidance. The Concept Release went out last summer and the
17 proposal went out last December.

18 The second step was for both the SEC and the PCAOB
19 to move forward in the revision of Auditing Standard Number 2
20 and that is certainly a critical part of all of this. So,
21 again, in following through on that, in December the PCAOB,
22 as you know, actually proposed two standards to achieve this,
23 two new auditing standards.

24 One was called An Audit of Internal Control Over
25 Financial Reporting That Is Integrated With An Audit Of

1 Financial Statements. That's the standard that was designed
2 to replace AS2. And, as you know, we commonly refer to that
3 as AS5 even though it hasn't actually earned that number yet.

4 And the second standard was a new standard on
5 Considering And Using The Work Of Others in an Audit.

6 The comment periods for both our proposal and the
7 PCAOB's proposals ended in February. We received over 200
8 letters the PCAOB received about 170. The staff's analysis of
9 those letters has, I think it's fair to say, very much
10 reinforced the importance of this critical interplay between
11 our proposal on Management Guidance and the PCAOB's proposed
12 auditing standard. And, really, in a moment, Conrad and the OCA
13 staff will take us through and elaborate on that theme.

14 I guess I just wanted to make one further comment,
15 and that is that I really wanted to acknowledge the
16 cooperative efforts that have occurred both within the SEC
17 staff and in particular between the SEC staff and the PCAOB
18 staff on this project. And, finally, I fully appreciate
19 that investors are relying on us and deserve our
20 hard work and our team work in all of this as we seek
21 to find the right balance to improve the implementation
22 of 404. I believe we are moving in that
23 direction.

24 So that's it on my comments. I'd also, like to
25 mention to my right is Carol Stacey who is the Chief Accountant

1 in the Division of Corporation Finance and one of the key
2 participants in this project.

3 And, Conrad, when the time comes, Carol and I will
4 be available to participate in answering the questions.

5 MR. HEWITT: Thank you, John.

6 As John emphasized, for both the Commission and the
7 PCAOB, replacing the auditing standard on ICFR known as
8 Auditing Standard 2 or AS2, represents a critical element in
9 the plans to improve the implementation of Section 404.

10 The PCAOB's December proposal was an important step
11 in the right direction towards encouraging external auditors
12 to adopt a top-down and risk-based approach to auditing a
13 company's internal controls.

14 As Chairman Olson noted, a large number of PCAOB
15 comment letters expressed support for the PCAOB's proposed
16 standards. However, the commentaries also provide a number
17 of suggestions for additional improvements.

18 A major theme on the comment letters is the
19 importance of considering whether the Commission and PCAOB
20 proposals work together to improve both the effectiveness and
21 efficiency of the implementation of Section 404.

22 To emphasize this point, a number of commentaries
23 sent the same letter to both the SEC and the PCAOB. For
24 example, commentaries believe that the differences between
25 the two proposals and the degree of detailed rules versus

1 objective-based guidance and the amount of professional
2 judgment each approach permits may make the auditing standard
3 and management guidance more difficult and costly to
4 implement.

5 The SEC staff currently is working closely with the
6 PCAOB staff as we revise our respective documents with the
7 goal of having them implemented this year. We are confident
8 that listening to your comments and questions this morning
9 will help us work through the remaining issues and result in
10 cost-effective guidance and standards that will maintain and
11 even further enhance investors' confidence in the financial
12 information that underlies our securities markets for large
13 and small companies alike.

14 The staff appreciates the time that each of you and
15 your staffs have already given to us through our work and
16 this important project. And let me thank you in advance for
17 the long hours that we will ask each of you to give us over
18 the next few weeks.

19 The staff has identified four significant issues
20 for discussion this morning. I will now turn it over to my
21 Deputy for Auditing and Professional Practical Issues, Zoe-
22 Vonna Palmrose, who along with the OCA staff members, Michael
23 Gaynor, Nancy Salisbury, Brian Croteau, and Josh
24 Jones, will describe each of the four issues in turn giving
25 you an opportunity to discuss each issue before we proceed to

1 the next one.

2 We, of course, would be happy to answer any
3 questions that any Commissioners might have about any of the
4 issues.

5 MS. PALMROSE: Thank you, Conrad.

6 Chairman Cox and members of the Commission, as
7 Conrad said, the staff has identified four issues which we
8 believe are the most significant matters that the PCAOB staff
9 should address prior to recommending final audit guidance to
10 the Board.

11 We have some thoughts on these issues we'd like to
12 communicate to the PCAOB staff provided that the Commission
13 supports such communications.

14 The issues that we would like to discuss with the
15 Commission today and obtain your support for communications
16 with the PCAOB staff are the following. First, more closely
17 align the proposed audit standards with the Commission's
18 Management Guidance.

19 Second, improve the section and related guidance in
20 AS5 on scaling the audit for smaller companies.

21 Third, clarify the auditor's ability to exercise
22 judgment based on the circumstances of the individual
23 auditing engagement to determine the audit procedures and
24 tests required to support the opinion on internal control
25 over financial reporting.

1 And, fourth, utilize broader principles in
2 proposing guidance on considering and using the work of
3 others in the audit.

4 Let me now focus on the first issue, alignment.
5 The Commission and the Board both received a great deal of
6 feedback in the comment period that indicated the need for
7 the two sets of guidance to be better aligned.

8 This essentially considers how the Commission's
9 proposed interpretive guidance and the PCAOB's proposed
10 auditing standards interact. Although the letters covered a
11 number of areas in which the proposed auditing standards and
12 our interpretive guidance could be better aligned, the
13 comments can be summarized into two broad categories.

14 The first category receiving many comments is the
15 apparent difference in the overall approaches of the two
16 proposals. A general reaction from comment letters on both
17 the Commission's and the PCAOB's proposals is that the
18 Commission's proposed interpretive guidance is more
19 principles-based and allows management to exercise
20 appropriate judgment in designing and conducting an
21 evaluation that is tailored to its company's individual facts
22 and circumstances.

23 On the other hand, some commenters raised concerns
24 that the PCAOB's proposed guidance, while improved from AS2, is
25 still very prescriptive and more prescriptive relative to the

1 SEC's guidance. As such, commenters were concerned that it
2 reduces the auditor's ability to use professional judgment to
3 appropriately tailor an efficient and effective audit
4 approach to the customized system of ICFR of individual
5 companies regardless of size or the methods and procedures
6 management implements for evaluating their effectiveness.

7 Commenters expressed concerns that the result of
8 more prescriptive auditing standards will be to drive
9 management to perform unnecessary work for the sole purpose
10 of enabling their auditors to comply with the PCAOB's audit
11 standards.

12 Essentially the concern is that as drafted the
13 auditing standard likely places management in the untenable
14 position of having to decide to either pay the auditor to
15 complete unnecessary testing documentation or do it
16 themselves.

17 As one example of the level of prescriptiveness in
18 the proposed AS5, comment letters point out that there are a
19 large number of musts and shoulds. This is significant
20 because the PCAOB has defined via its rule 3101 on certain
21 terms what must and should mean. Musts are mandatory and
22 shoulds are presumptively mandatory performance requirements
23 for auditors.

24 Moreover, the PCAOB's Auditing Standard Number 3
25 provides audit documentation requirements that when combined

1 with the musts and shoulds could have a significant impact on
2 the level of audit effort.

3 Auditors must explicitly comply with each
4 performance and documentation requirement, so
5 commenters expressed concern that not only can prescriptiveness
6 lead to reluctance by auditors to exercise well-reasoned
7 judgments but also PCAOB inspections would focus
8 compliance with prescribed requirements rather than
9 on achievement of the standard's overall audit
10 objectives.

11
12 The second category of comments on alignment
13 involves differences in defined terms between the
14 Commission's proposed Management Guidance and the PCAOB's
15 proposed guidance for auditors.

16 For example, the proposals contain differences in
17 the language describing what constitutes a material weakness,
18 how individual controlled deficiencies should be aggregated
19 when evaluating whether a material weakness exists and in the
20 guidance describing circumstances ordinarily considered as
21 strong indicators of a material weakness.

22 In light of the comment letter feedback the staff
23 believes that one area to strive toward is a consistent set
24 of definitions to be used in defining those conditions in
25 internal control that are disclosed to investors pursuant to

1 our rules.

2 To address commenter concerns about confusion and
3 misinterpretation among auditors, issuers and investors and
4 to increase efficiency, the staff believes that the alignment
5 concerns raised in the comment letters should be addressed.

6 As a result the Commission staff proposes to work
7 with the PCAOB staff to achieve a more principles-based
8 approach to the proposed audit standards as follows.

9 First, to identify and eliminate any unnecessarily
10 prescriptive requirements where the overall principle or
11 objective has been well stated.

12 And, second, to harmonize the key terms and
13 definitions in the Commission's Management Guidance and Rules
14 and the PCAOB's definition in its two proposed auditing
15 standards.

16 Chairman Cox, the staffs of OCA and Corp Fin would
17 be happy to discuss any questions that you and the
18 Commissioners might have on the staff's suggestions.

19 CHAIRMAN COX: Well, I'd like to thank each of you,
20 Conrad, John and Zoe-Vonna, for your job in laying out a
21 landscape on this first topic.

22 And, Zoe-Vonna, you mentioned that essentially we've
23 got two issues to deal with in this area of coordinating our
24 approaches.

25 I'll also compliment our commenters for themselves

1 being so coordinated. I notice that about 70 percent of the
2 commenters proposed that we do a better job in this area. So
3 they were all coordinated in their message. And I also note
4 that many of the commenters themselves submitted joint comment
5 letters on the PCAOB standard and on Management Guidance. So
6 at least the regulated community is showing a high level of
7 coordination and I think the fact that the comments are
8 coordinated will make it easier for us to take them into
9 account at the SEC and the PCAOB.

10 I'd like to get to the heart of this and ask first,
11 why is it better for investors to have auditors using their
12 professional judgment and why is it better for smaller
13 companies? How will it make it a better process for them
14 when they are complying with Section 404?

15 MS. PALMROSE: Well, the reality is that
16 professional standards which allow for the use of judgment in
17 executing one's responsibilities represent the touchstone of
18 any profession. Standards need to provide a floor, not a
19 ceiling for auditor performance.

20 And, as we struggled with the consequences of
21 financial reporting complexity, it is important to resist the
22 temptation to write prescriptive audit standards.
23 Principles-based standards are the key to high quality time
24 invariant audit standards.

25 CHAIRMAN COX: On the second topic on definitions, I

1 think I can understand as a general matter why we don't want to
2 confuse everyone, why we don't want to have one definition in
3 place in the PCAOB standard and use the same term with a
4 different meaning as part of the same process in our Management
5 Guidance. But can you give me an example of why this is
difficult?

6 MS. PALMROSE: Why it's difficult to align them?

7 CHAIRMAN COX: If it's such an obvious principle,
8 how come we're not finished?

9 MS. PALMROSE: Well, we have to confess and Carol
10 can help me here a little bit, but we actually elicited
11 questions on this very topic. And in part we knew that we
12 weren't aligned in some ways and the intent was to solicit
13 feedback on the issues where we differed. So, in some sense,
14 this was intentional.

15 Now, there also were nuances that we didn't
16 appreciate the impact of, so there are slight differences in
17 wording at times that we didn't appreciate the implication of
18 and so it is very useful that we heard in regards to these.

19 So some of this is that we knew we were going to
20 get feedback and it would help us make decisions and some of
21 it was a surprise and, thus, is a very important issue for
22 us.

23 And I think Jeff Steinhoff from the GAO sensitized
24 us to the importance of this for everybody. In other words,
25 it is important to have terminology that is converged and

1 consistent and harmonized across auditing in all sectors.
2 And so we very much appreciate that for users across all
3 markets.

4 MS. STACEY: And I agree with Zoe-Vonna. I think it
5 was very important that we received comments in this area
6 rather than just spitting back the definitions from the
7 original AS2, let's think through them again and have other
8 people and commenters begin to focus more because they're very
9 critical to scoping decisions and other decisions in the
10 audit. So it was very important for people to comment on
11 that.

12 It also brought up the question as to whether we
13 should have the definitions in our rules and the PCAOB's
14 definitions should be obviously harmonized to whatever we
15 decide to put in ours. So that's an open question also at
16 that point which we think is very important.

17 CHAIRMAN COX: And how do you think you're going to
18 resolve that?

19 MS. PALMROSE: Well, the staffs do plan to work
20 together to get agreement on the definitions to make sure
21 that we do agree on what the words will say. And then we're
22 going to work through exactly how to accomplish the latter
23 part of what Carol has suggested here.

24 MS. STACEY: I think we will have the definitions,
25 obviously, either in Management Guidance or if we believe

1 they need to be elevated to the rule level, we will propose
2 that. So we have yet to work through that between ourselves
3 and the PCAOB, but that is a focus area of ours.

4 CHAIRMAN COX: All right. Commissioner Atkins.

5 COMMISSIONER ATKINS: Thank you, Mr. Chairman. And
6 thank you very much for calling this meeting to talk about
7 this most important and vexing issue.

8 And thank you very much to you all on the staff for
9 all of your hard and dedicated work. I think you're doing a
10 great job, so thank you very much for organizing this.

11 In talking about AS5, which clearly I
12 think is a significant improvement over AS2, there is
13 widespread acknowledgement that AS2 didn't get us to where
14 we need to be and now we have no choice but to get it right
15 here the second time around.

16 There still appears to be a concern that the new
17 standard will force auditors to focus on issues that pose
18 little risk to reliable financial reporting. We heard from GAO
19 and others about how important it is to have a risk-based
20 approach and also, as you were just saying, investors
21 ultimately pay for all of wasted time not only of
22 auditors but of management.

23 What can we do to make sure that this standard, as
24 well as other auditing standards, does not have the effect of
25 wasting time and is really focused on a risk-based

1 type of approach?

2 MS. PALMROSE: Perhaps I can start off and respond
3 to that question and then others can join in if they want to
4 add to it.

5 First of all, I think it's really important and
6 this is something that we are talking a lot about and it's
7 coming out through the comments here this morning that
8 judgment is very important and that prescriptiveness is not
9 synonymous with rigorous judgments. In other words, the
10 standards need to recognize and empower auditor judgment in
11 ways that are objectives-based but without the structure around
12 it that drives down into the details of unnecessary work.

13 And I think it is also important to consider that
14 as we look at auditing standards and make choices about
15 auditing standards that affect the financial reporting and
16 disclosure landscape that we don't lose sight of all the
17 changes that have occurred since 2002 including in governance
18 related to corporations and the role of management, boards and
19 audit committees as well as governance of the profession.

20 In other words, audit standards are very important
21 but they are just one of the tools in the regulator's tool
22 kit. So I think it is important to keep that background in
23 mind, too, as we think about the audit standard itself.

24 COMMISSIONER ATKINS: So you are saying they
25 shouldn't be viewed in isolation.

1 MS. PALMROSE: Exactly.

2 COMMISSIONER ATKINS: It's part of an organic goal.

3 MS. PALMROSE: Exactly. They're part of, yes,
4 they're part of a broader array of regulatory activities
5 here.

6 COMMISSIONER ATKINS: Okay. Well, in this respect
7 I just have one other question. Will your proposed work with
8 the PCAOB on alignment address the concerns about
9 the manner in which their standard allows for aggregation of
10 unrelated accounts for the purposes of determining, for
11 example, whether an account is significant and whether the
12 combination of control deficiencies for the purposes of
13 identifying significant deficiencies and material weaknesses
14 are dealt with.

15 MS. PALMROSE: Yes. Yes. That's one of the
16 elements I alluded to in my remarks, one of the
17 components that we will be considering.

18 But perhaps one of the staff would like to join in
19 and give a little bit more context on that.

20 MR GAYNOR: We did include in our proposed
21 Management Guidance some guidance on the aggregation of
22 deficiencies. The notion of aggregation is something that's
23 existed for some time in the financial statement audit. You
24 know, when auditors encounter account balances that contain
25 errors, they do have to consider those errors in the

1 aggregate as well as individually.

2 And so the same concept carries over to the
3 internal control audit. Unfortunately, there is an added
4 dimension of complexity because we're now -- we're in the
5 control space as opposed to known errors. We're in what is the
6 likelihood that there could be a material error. And those
7 judgments clearly are more difficult, more complex for both
8 management and auditors. And so it is clearly an important
9 topic that we are studying and interested in working with the
10 PCAOB on to ensure that management and the auditors have
11 similar guidance in this regard.

12 COMMISSIONER ATKINS: Well, this leads into what
13 we'll talk about later with respect to materiality, but I
14 think this is one very important thing where we need to get,
15 you know, our management guidance aligned with their audit
16 standard to make sure that there's no gap in the middle.
17 Thanks.

18 CHAIRMAN COX: Commissioner Campos.

19 COMMISSIONER CAMPOS: Thank you.

20 Let me add quickly my appreciation to the staff
21 here at the SEC for all the efforts that have been put forth
22 so far to bring us to this particular point and in particular
23 the willingness to work with the PCAOB, their staff and, of
24 course, the Board and the leadership there in terms of our
25 two agencies working together. And I think to this point

1 being very committed jointly to get and to resolve a very
2 challenging regulatory dilemma which is to essentially have
3 investor protection with a reasonable and rational cost in
4 particular for the small issuers.

5 I believe that sometimes you need to just be very
6 basic and general. And so I'm going to start at that
7 particular level just in the event that there is
8 something that's been missed or maybe our audience hasn't
9 quite heard it yet.

10 And that is that there seems to be from various
11 questions a sense or an accusation that somehow the SEC and
12 our staff with respect to 404 cares less about investors and
13 cares more about reducing the cost of implementation of
14 audits.

15 Zoe-Vonna, how would you answer that concern?

16 MS. PALMROSE: Not at all. Not at all. Would that
17 be the strongest way I can say it?

18 First of all, the staff is completely committed,
19 strongly believes that investors in small companies are
20 entitled to the same disclosures on ICFR as investors in
21 large companies.

22 And we look at all of our -- the comments and our
23 assessment of changing management -- revising management
24 guidance and the revisions to the audit standards through
25 that lens.

1 What we are really trying to do is make this a more
2 effective audit process thinking in terms of an integrated
3 audit which I think is an important element for both large
4 and small companies alike. We never think in terms of
5 efficiency without thinking about what is the impact on audit
6 effectiveness. And, if it's positive, that's great. If it's
7 neutral, okay. But there is never any thought about
8 compromising audit effectiveness to obtain so-called
9 efficiencies.

10 In other words, efficiency is about unnecessary
11 work that actually can diminish audit quality, not improve
12 it.

13 CONRAD HEWITT: I would like a footnote. As
14 Zoe-Vonna has just said about the investor, protection of the
15 investor, that excessive cost of an audit harms the investor's
16 value in that company in the marketplace. Those costs can be
17 used for other more important things of the company, such as
18 customer satisfaction, product development and those types of
19 things. So there has to be a good balance and that's what
20 we're trying to approach here is a good balance for the
21 investor.

22 COMMISSIONER CAMPOS: I trust no one at any policy
23 level has indicated to you that investor interests and
24 investor protection is less important?

25 MS. PALMROSE: No, not at all. In fact, that's what

1 we are constantly thinking about. And, as I said just to
2 reinforce, we believe, we firmly believe that investors in
3 all companies are entitled to these disclosures and that this
4 is doable and that's what we are working to achieve.

5 COMMISSIONER CAMPOS: I think Mike Gaynor put it to
6 me another way when we were -- when he was briefing
7 me, and he said that the goal of this process, I
8 quote, "is to increase both the effectiveness of the audit
9 and the efficiency in conducting the audit and if the only
10 outcome of a proposed change to the standard is fewer
11 disclosures to investors and less public reporting without
12 gains in both the effectiveness and efficiency, then there is
13 no reason to make a change."

14 Is that a fair summarization of what we're trying
15 to do?

16 MS. PALMROSE: Well, let me speak for my staff.
17 Oftentimes Mike is very eloquent. He also has a great wit,
18 too.

19 COMMISSIONER CAMPOS: I thought he was witty, too.

20 MS. PALMROSE: I can't dispute that. But the answer
21 is it's very well stated.

22 COMMISSIONER CAMPOS: I'm trying to fit my sub-
23 questions where I can still say it's only been two questions.

24 MS. PALMROSE: We're auditors here.

25 COMMISSIONER CAMPOS: But are you using judgment?

1 It seems to me that the paradigm that
2 we're struggling with is what our chairman alluded to a
3 little while ago in his questioning. And that is in the
4 overall harmonization of our guidance, you spoke
5 essentially that it's principles versus prescriptive-ness or
6 being prescriptive as the major difference.

7 And what that leads you to is the situation in
8 which, again, as a paradigm is it appropriate from a
9 regulator's perspective to seek to give the auditor judgment,
10 flexibility, the ability to use different aspects of evidence,
11 and conclude that that will lead to better audits and
12 better effectiveness or a better, effective audit versus a
13 checklist in which the people who don't agree with that would
14 say, "Well, you just can't trust in a given situation an
15 auditor to get to the right conclusion or in this particular
16 context." So you need to find some very specific rules to
17 make sure you end up with a minimum of audit work.

18 How do you square that in terms of that debate?

19 MS. PALMROSE: Well, I think Jeff Steinhoff again
20 alluded to this and set it up nicely in terms of the concern
21 over form versus substance. And the problem is when you try
22 to anticipate from Washington, D.C., what all the facts and
23 circumstances will be for all the companies around this great
24 world of ours, you just can't do it.

25 You have to be able to allow auditors and

1 management to make judgments about the risks within their own
2 organizations and the auditor to bring to the table evidence
3 from that risk assessment, from management's process as well
4 as from the financial statement audit in an integrated audit
5 sense. And it's not possible to anticipate all of those
6 facts and circumstances and prescribe responses to them.

7 So that's why it is so important to have judgment-
8 based standards and that's what we've had. Auditing standards
9 have always been judgment-based and they were scalable. We
10 have had one set of standards for all companies regardless of
11 size that were scalable because they establish the over-
12 arching principles and objectives behind the judgments
13 without prescribing the methodology for accomplishing that.

14 COMMISSIONER CAMPOS: Okay. One small push just to
15 keep you, keep that great intellect going. What do you say
16 to those who have said, "We have seen in these scandals, we
17 have seen in the failures that whether it's on the part of
18 management or whether it's on the part of auditors that that
19 type of freedom in judgment doesn't produce results."

20 MS. PALMROSE: Those were not a failure of the
21 standards themselves. And I think this is an important
22 element when I referred to the tools in the regulatory tool
23 kit.

24 Essentially, we have a process in place now with
25 the PCAOB in which we can, the PCAOB can assess the role of

1 standards in any of those failures. But largely the analysis
2 of those failures have been one of performance not standards.

3 Now, it isn't that we can't learn lessons and
4 improve. For example, I think the fraud standard that was
5 promulgated it wasn't really in response to the failures but
6 it did anticipate some of the issues that came out from those
7 failures. But, again, it was judgment-based without
8 prescribing a methodology. It identified factors to take
9 into consideration in making your judgments as an auditor.

10 So hopefully that provides a context for
11 understanding that the response to those is not going to be
12 one of a form solution that will only likely engender
13 decisions that are not robust and productive.

14 COMMISSIONER CAMPOS: I appreciate that answer and
15 I just want to make the point that we should never take for
16 granted that this dichotomy is totally accepted or totally
17 understood. And I hope we do -- both us and the PCAOB -- do a
18 good job of constantly expounding on why a judgment-based,
19 top-risk-down approach produces the more effective audits.
20 And I'm done. Thanks.

21 CHAIRMAN COX: Thank you. Commissioner Nazareth?

22 COMMISSIONER NAZARETH: Thank you very much. I'm
23 very heartened by the conversation today because I think it
24 really evidences that our goals are very significantly
25 aligned between the SEC and the PCAOB. I mean our focus is

1 on investor protection and on integrity of internal controls.
2 Our focus seems to be on a top-down risk-based approach to
3 the audits. And certainly it's on effectiveness and
4 efficiency of implementation of Section 404.

5 So it seems to me that, listening to all this, what
6 we're really talking about is where are the appropriate
7 refinements in order to achieve those common goals. And,
8 again, it's been a very constructive process as I think
9 everyone can hear between the PCAOB and their staff and the
10 SEC and our staff.

11 I thought I'd just ask two questions. One, again
12 under this alignment topic, we've talked about harmonization
13 of key definitions. And harmonization is like mom and apple
14 pie. Of course we want the definitions to be the same. But
15 as I vote in favor of authorizing you to go forth and
16 harmonize, I want to be sure I understand what exactly you're
17 going to harmonize.

18 So, for instance, when the staff talks about the
19 definitions, are you in any way suggesting that you are going
20 to recommend new definitions? Or are you talking about
21 harmonizing the definitions consistent with what we proposed
22 and the PCAOB proposed?

23 MS. PALMROSE: Well, I think Carol can jump in here
24 again. I think there are slight differences in some areas
25 between our definitions that I suspect are not going to be

1 impediments at all. We have a slightly different one.

2 Now, I mean I have to acknowledge that the comment
3 letters do make -- there are some comment letters that make
4 suggestions for more substantive changes in some definitions.
5 And, in all honesty, we haven't made any decisions at all.
6 We're still in the deliberation stage. I think it's
7 reasonable to think it would be difficult to make major
8 changes in some of the key definitions.

9 COMMISSIONER NAZARETH: I wouldn't think without
10 Commission approval you would be suggesting material
11 changes to the definitions.

12 MS. PALMROSE: I think that would be a necessity if
13 it was to occur and especially since they do affect so many
14 other areas.

15 COMMISSIONER NAZARETH: Right. Particularly
16 definitions like material weakness --

17 MS. PALMROSE: Oh, yes. Yes.

18 COMMISSIONER NAZARETH: That would be the whole game.

19 MS. PALMROSE: Yes. I think we just have a slight
20 difference in that one between our two guidance and it's just
21 a nuance and I suspect that's easily resolvable.

22 COMMISSIONER NAZARETH: Right. That's what it
23 looked like to me also.

24 MR. WHITE: But there are comment letters that
25 are suggesting quite significant changes in the definitions.

1 MS. PALMROSE: There are comment letters that suggest
2 much more radical changes, and it would be inappropriate
3 for me to say the staff has made conclusions.
4 But it would be appropriate to say if we made a major change
5 that it would require obviously Commission approval.

6 COMMISSIONER NAZARETH: Right. Okay. Also,
7 Chairman Olson indicated in his opening remarks that
8 management's and the auditor's evaluations of internal
9 control over financial reporting are complementary but
10 different and for that reason requires an audit standard with
11 more structure than is needed for management guidance.

12 Does the staff believe that the approach should be
13 identical or that there are reasons for some differences in
14 the approach?

15 MS. PALMROSE: Let me maybe have Mike Gaynor who --
16 the eloquent Mike Gaynor --

17 COMMISSIONER NAZARETH: Who is witty.

18 MS. PALMROSE: The eloquent and witty Mike Gaynor --

19 COMMISSIONER NAZARETH: The pressure is on.

20 MS. PALMROSE: Who has spent a good deal of time on
21 management guidance talk a little bit about that issue.

22 MR. GAYNOR: Well, I don't know what was more
23 embarrassing having Commissioner Campos quote me or some of
24 the other remarks.

25 But in any event, in response to your question

1 about whether the staff believes that management's evaluation
2 process and the auditor's approach should be identical, and
3 the answer to that is no. We don't believe that the
4 processes should necessarily be identical.

5 We agree with the view that Chairman Olson
6 articulated this morning, that management's knowledge of its
7 business and its daily interaction with its internal control
8 results in the auditor and management coming at their
9 respective responsibilities to report on internal control
10 from different places.

11 Moreover, because the auditor is also performing an
12 integrated audit, that is an audit of both the financial
13 statements and an audit of internal control, the approach
14 that the auditor takes will be significantly influenced by
15 what's required to issue his or her opinion on the financial
16 statements as well.

17 However, having said that, the staff does believe
18 that the manner and to what extent these differences require
19 different approaches is a very important question and one
20 on which we look forward to working with the PCAOB staff.
21 A question that bears on our minds is this fundamental
22 question of if the different or the need to scale internal
23 control evaluations in the management space because of the
24 different sizes and companies' different complexities, it
25 seems like that same phenomenon -- size and complexity --

1 exists in the audit space as well. And so we need to sort of
2 work through the extent to which those approaches need to be
3 the same and reconcile them or at least help constituents
4 understand, you know, why they're different and to what the
5 implications of any differences are.

6 COMMISSIONER NAZARETH: Thank you.

7 CHAIRMAN COX: Commissioner Casey?

8 COMMISSIONER CASEY: I also want to thank you for
9 your comments particularly in response to Commissioner Campos
10 in appreciating the traditional approach in auditing and
11 taking -- the necessity, the importance of judgment for the
12 auditor, flexibility of being able to exercise that judgment.
13 And I think GAO also touched on that inasmuch as they've
14 been, they've been taking a risk-based top-down approach for
15 some time in assessing internal controls. So I thought that
16 was extremely constructive to appreciate that.

17 As a follow-on to the question that was just asked,
18 inasmuch as our Management Guidance hopes to provide sort of
19 workable guidance to issuers as well as acceptable frame
20 works that are flexible to address particular characteristics
21 of smaller companies in particular. As you work through some
22 of the alignment issues with the PCAOB, in light of the
23 Chairman's comment that they do have different functions or
24 different purposes, how important will that be? I guess
25 I'm asking will that be important to our achieving the

1 benefits of Management Guidance if we are not able to
2 leverage off of the benefits that we would anticipate coming
3 from that flexibility?

4 MS. PALMROSE: I would say it's very important and
5 it's part of the motivation for doing this, in particular,
6 looking deeply at the alignment question.

7 But maybe Mike would add a few more comments on
8 that, too.

9 MR. GAYNOR: Yes, you know, we've talked a lot
10 this morning about the alignment theme and the feedback that
11 we got and I think Carol or Zoe-Vonna mentioned that we in fact
12 solicited feedback on alignment differences.

13 We knew when we were there, we were informed by
14 some of the impact and the extent to which a lack of
15 alignment issues would preclude management from achieving the
16 improvements and efficiency and effectiveness that they
17 desired.

18 And, so, we're very mindful of that. We are
19 working closely with the PCAOB to understand what it is in
20 the auditing standard that is causing the dialogue between
21 auditors and management to be of the nature that it is that
22 it's driving these concerns and we will look very closely at
23 what we can do to try to improve that.

24 MS. PALMROSE: I just wanted to add, too. We do
25 have some comment letters that are very helpful, too, in

1 terms of making suggestions. And we're in the process of
2 analyzing those and hopefully we will be able to incorporate
3 those, too.

4 COMMISSIONER CASEY: Sort of as follow-on to some
5 of the concerns with the prescriptiveness in the underlying
6 standard, much of the criticism -- not "much" -- some of the
7 criticism that was levied against AS2 because of its highly
8 prescriptive and detailed approach was that it contributed to
9 the PCAOB inspection process which sort of focused on
10 technical compliance with the prescribed requirements rather
11 than more looking at the standard's overall objective.

12 I know that Chairman Olson mentioned this
13 morning that it will be a key component and GAO has also made
14 it clear that that will be important.

15 Inasmuch as PCAOB, the inspection process will have
16 to alter -- if we're successful in aligning both the
17 Management Guidance and the Standard 2 infusing greater
18 judgment and flexibility for the auditor, how will that
19 inspection process have to change in terms of just mind set
20 in examining and even as much as in our role which I know
21 that John has spoken about our role in working with PCAOB and
22 inspecting their inspections.

23 I mean how do we have to change our mind set and
24 expectations in terms of examination if we're to achieve the
25 true benefits that we're talking about here?

1 MS. PALMROSE: Well, let me start off in responding
2 and then others can add on. But I think it starts with,
3 first of all, an education by the PCAOB standard-setting
4 group for the inspection process. So, it's very key that
5 there be alignment within the PCAOB about what they mean by
6 the standard so that the inspectors understand what the key
7 elements of it are and can then focus on the objectives
8 rather than, you know, the minutia of the compliance aspect.

9 I also think there's probably opportunities to
10 think about how to approach an inspection as well as
11 communicate the results so that it informs both auditor
12 performance as well as standard setting.

13 For example, there's ways of communicating best
14 practices that the firms can learn from and there's also
15 feedback into the standard setting process to refine if --
16 and, again, they have communication devices if people are
17 misunderstanding or misinterpreting, there are ways that
18 those can be addressed and they can be addressed in a timely
19 fashion.

20 So I think all of those are going to be important
21 elements and they should work seamlessly, if we can get to
22 that spot in terms of the standard-setting process and the
23 implementation of it. And this will be one of the examples
24 of it, too.

25 MR. HEWITT: I just might add on this point that

1 the implementation of the standard will be very, very
2 important assuming we have an excellent Standard AS5.
3 The PCAOB will have to train their staff
4 extensively into the new standard before they're out in the
5 field inspecting the external auditing firms. And that
6 behavior will have some effect on whether or not the standard
7 is effectively implemented.

8 Also, the external auditing firms will have to do
9 the same. They will have to train, retrain their staff on
10 this new standard which will be very important as to the
11 implementation of the standard.

12 And so I think we'll be looking at that aspect of
13 it in our inspection process of the PCAOB.

14 COMMISSIONER CASEY: Thank you very much.

15 CHAIRMAN COX: Is there any further discussion the
16 Commissioners would like to have on this first topic?

17 (No response.)

18 CHAIRMAN COX: If not, then to wrap up this portion
19 of the discussion, I would like to summarize the staff's
20 recommendation on alignment and ask the Commissioners to
21 express their support or disagreement with this approach.

22 Specifically on alignment, the SEC staff proposes
23 to work with the PCAOB staff (1) to identify and eliminate
24 any unnecessarily prescriptive requirements where the overall
25 principle or objective has been well stated and (2) to

1 harmonize the key terms and definitions in the Commission's
2 Management Guidance and Rules and the PCAOB's definitions in
3 its two proposed auditing standards.

4 Do the Commissioners support the staff's approach?

5 COMMISSIONER ATKINS: Aye.

6 COMMISSIONER CAMPOS: Yes.

7 COMMISSIONER NAZARETH: Yes.

8 COMMISSIONER CASEY: Yes.

9 CHAIRMAN COX: Yes.

10 And the recommendation is approved so let's move on
11 to the staff's second recommendation on making AS5 scalable
12 for smaller public companies.

13 And I understand that Zoe-Vonna Palmrose is going to
14 begin that presentation.

15 MS. PALMROSE: Thank you. Let me just start us off.

16 The next issue is, as the Chairman said, we would like to
17 discuss relates to the section in the PCAOB's proposed audit
18 standard entitled, "Scaling the Audit."

19 Nancy Salisbury will briefly describe the concerns
20 raised by the commenters and possible suggestions for
21 improvements. Following Nancy's remarks, the staffs of OCA
22 and CorpFin would be happy to discuss any questions that you
23 and the Commissioners might have on the staff's suggestions.

24 Nancy?

25 MS. SALISBURY: Thank you. The PCAOB received a

1 number of comment letters in response to the section in AS5
2 on scaling the audit that raised concerns with the staff that
3 the guidance may not have been understood as intended.

4 A number of the comments especially those from
5 smaller companies or their representatives noted that it was
6 still unclear how auditors could under the guidance tailor
7 the nature, timing or extent of their procedures.

8 In fact, some commenters raised concerns or
9 questioned whether the documentation requirement in this
10 section would actually add unnecessary work rather than
11 reduce work.

12 In our view, some of the issues raised by the
13 comment letters can be dealt with by the PCAOB as they
14 address some of the prescriptiveness issues of the proposed
15 standard pursuant to the conversation we just completed.

16 Additionally, we believe other promising ways to
17 ensure the auditors appropriately tailor their audits to the
18 unique facts and circumstances of smaller companies is to
19 directly incorporate guidance throughout the various sections
20 of the audit standard as applicable rather than including
21 these comments only in this one particular section of the
22 standard.

23 Further, we think another approach could be to
24 better illustrate how the auditor can maximize consideration
25 of the work performed in support of the financial statement

1 audit in the audit of ICFR.

2 Finally, many of the issues that smaller companies
3 present may also exist in the audit of smaller locations of
4 larger companies. We support having one auditing standard
5 that is applicable to all companies regardless of size. So
6 it seems appropriate to us that any scaling concepts
7 ultimately outlined in the audit standard should be focused
8 on the auditor's consideration of the facts and circumstances
9 of each company rather than those concepts being applicable
10 only to companies of a certain size or complexity.

11 We believe that the PCAOB can improve the guidance
12 on scaling the audit for smaller companies and the Commission
13 staff proposes to work with the PCAOB staff on the following
14 suggestions. First, extend the scaling concepts throughout
15 AS5 to tailor the audit to the control systems of smaller
16 companies rather than requiring smaller companies to conform
17 their appropriately tailored control systems to an auditing
18 standard.

19 Second, ensure the appropriate integration of the
20 financial statement audit to the auditor's consideration of
21 the test necessary for the internal control audit.

22 And then third, ensure the applicability of scaling
23 concepts without any unnecessary conditions focusing on the
24 facts and circumstances of each company.

25 And, thank you, we'd be happy to take any of your

1 questions at this time.

2 CHAIRMAN COX: Well, thank you, Nancy and Zoe-Vonna.

3 Since the comments that we've received are
4 obviously a focal point of the remaining work, let me just
5 begin by asking what kind of comment did we get on this
6 particular topic from smaller companies?

7 MS. SALISBURY: The comments from the smaller
8 companies were relatively consistent with the kind of
9 comments we receive from all commenters. In general they were
10 very supportive of the direction that the PCAOB was going.
11 But a lot of them raised concerns that it was unclear exactly
12 how the guidance in this section could -- would actually
13 impact the testing or the work that auditors are going to
14 perform as they complete their testing.

15 CHAIRMAN COX: And then what's the answer to that
16 question?

17 MS. SALISBURY: Well, we think that the PCAOB could
18 better illustrate for auditors by putting in throughout
19 various sections of the standard that they could be putting
20 in illustrative examples or contrast with how a larger
21 company might do it that a smaller -- an auditor of a smaller
22 company might see this, for example. You know, illustrations
23 like that would help clarify for auditors of smaller
24 companies exactly how the principles outlined in the scaling
25 section could impact their audit.

1 CHAIRMAN COX: Zoe-Vonna?

2 MS. PALMROSE: I was just going to add we did that
3 in Management Guidance and got positive feedback on that. So
4 we thought it might be a useful approach within the auditing
5 standard, too.

6 CHAIRMAN COX: This leads us into another topic.

7 Nancy, you mentioned extending this throughout the
8 standard. What does the SEC staff mean when we talking about
9 extending the scaling concept throughout the PCAOB standard?
10 What exactly does that mean?

11 MS. SALISBURY: Well, as Zoe-Vonna mentioned, in the
12 Management Guidance, we tried to provide in places where we
13 thought it was appropriate and beneficial, we tried to
14 provide illustrative examples for specifically what smaller
15 companies could anticipate or potentially how a smaller
16 company approach might be different and we thought that it
17 would be helpful if the PCAOB challenged their standard and
18 looked for situations or areas where they could do the same
19 to better illustrate the principles in the scaling section.

20 CHAIRMAN COX: So the approach to extension is
21 illustration and we would sprinkle those throughout the
22 standard?

23 MS. PALMROSE: Illustration is probably -- your
24 vocabulary is so wonderful, you would probably get a little
25 more precise term here --

1 CHAIRMAN COX: I think that was a backhanded way of
2 saying I picked the wrong word; wasn't it?

3 MS. PALMROSE: It would, it would provide some
4 specificity around the context of that objective within a
5 smaller company context. So it's not an example. It's not
6 asking for examples per se, but to give a linkage of the
7 objective or concept into the smaller company context and
8 talk about the audit implications of it that way.

9 CHAIRMAN COX: All right. Commissioner Atkins?

10 COMMISSIONER ATKINS: Thank you, Mr. Chairman.

11 I think this concept is very crucial. Just
12 yesterday there was yet another bipartisan bill that was
13 dropped in the House along this line with respect to smaller
14 companies and we have gotten obviously many letters from
15 members of Congress in this regard. So we have to get this
16 right before we turn smaller companies over to this regime
17 that we've seen come down in the last year.

18 So I was curious, if you could give some
19 examples of the areas in which the PCAOB standard could be --
20 these concepts of scalability could be integrated into that
21 standard.

22 MR. HEWITT: I'll just give you one example for
23 small companies. They do operate in a quite different
24 environment than a mid-size cap or a large cap company. I'm
25 very familiar with small companies. I was on the board of

1 two or three of them.

2 For example, in the standard it calls for you to
3 look at the significant processes within the company as to
4 its internal controls of those significant processes. In a
5 smaller company, a significant process could be really the
6 budgetary process which they monitor daily and the board does
7 and the audit committee. In a larger company, you probably
8 might not find that situation. So it's a different
9 would be an example.

10 COMMISSIONER ATKINS: Well, I think what you were
11 talking about before with respect to integration of the audit
12 is extremely important with smaller companies and as the Senate
13 committee said back in the passage of Sarbanes-Oxley that
14 already high-quality audits have internal control procedures
15 worked into them. Unfortunately, that was one of the
16 problems with the AS2 -- that it completely veered away from
17 that and layered on something entirely new on top of it.

18 MS. PALMROSE: Could I reinforce that and say that
19 the staff really believes that that is a very important
20 consideration. I mean it is for all companies, but it is
21 especially so in the smaller company context and how the
22 financial statement audit informs the risk assessment for the
23 ICFR and vice versa.

24 COMMISSIONER ATKINS: Right.

25 MS. PALMROSE: It's just going to make both of them

1 better.

2 COMMISSIONER ATKINS: Well, in fact, one company
3 that I visited -- I've visited dozens of them over the last
4 year or so -- is audited by a Big 4 firm and they are
5 basically paying more to their -- for consultants and their
6 Big 4 auditor than they were paying their CFO and all the
7 people reporting to the CFO. So they are paying more to put
8 together -- I mean more to audit their financials and
9 therefore, for an audit than they were paying to put them
10 together, which is a terrible situation. That company had no
11 operating revenue. That's just an example of the problems that
12 are out there. So, hopefully, we'll be able to fix it through
13 this. With respect to the GAO testimony from Jeff Steinhoff
14 before, he talked about that accountants should not be bound by
15 a checklist and just being slaves to that type of thing. What
16 steps can we take to ensure that they aren't bound by
17 particular checklists before they are able to apply scalability
18 concepts but rather able to use their judgment? That sort of
19 slops into the next thing you're going to talk about, but
20 specifically, how can we ensure that they can use their
21 judgments with respect to scalability across a wide range of
companies?

22 MS. PALMROSE: I can start off and others can join
23 in but I think the first step is reconsidering the musts and
24 the shoulds within the standard. So that will help so
25 challenging as Mark Olson said that the PCAOB staff is doing,

1 challenging those is going to be an important consideration
2 because again remember that documentation sort of changes
3 your focus from the substance to the form of it. And it
4 should really instead cause you to think more rigorously and
5 deeply, not simply do it to document that you have done it.

6 So part of it is going to be challenging the
7 prescriptiveness of the musts and shoulds. So that is going
8 to be one important way.

9 And the other is challenging sort of the over-
10 arching architecture of defining a methodology for an ICFR
11 audit I think. And, so, that is probably worth thinking
12 about in that the financial statement audit, the standards do
13 not provide a defined methodology for everybody to use. They
14 establish guidance and principles that others then decide how
15 to implement their own methodologies.

16 COMMISSIONER ATKINS: Okay.

17 MS. STACEY: I also think it's important because
18 the reality is that the firms use checklists. And so it's
19 going to be important for us and for the PCAOB -- judgment is
20 important. And it's just not enough just to go through
21 the checklist and, "boom," you're done but
22 definitely reinforce that you don't necessarily
23 have to abide by the checklist for everything
24 and you can vary from that based on your judgment.

25

1 So, you know, I agree that's going to be a concern going
2 forward and it's going to continue to need reinforcement.

3 COMMISSIONER ATKINS: And a lot of it comes down to
4 training. I know a lot of the accounting firms sort of
5 drafted people from the HR groups and tax and what not and
6 threw them into this sort of environment to try to do these
7 404 audits which, you know, is questionable as to the
8 competency of that sort of thing.

9 So, hopefully, with respect to both our Management
10 Guidance and the Audit Standard 5 we'll be able to work these
11 examples in and give better guidance I think. Thanks.

12 CHAIRMAN COX: Commissioner Campos.

13 COMMISSIONER CAMPOS: Thank you. Again, the words,
14 scaling, scalability, it seems to me to be one of those
15 concepts that seems to have a lot of different
16 interpretations and I am hopeful that the staff will keep
17 reinforcing these principles and what it means by that.

18 For example, I think this entire Commission
19 strongly supports the idea of a single standard under AS5 for
20 companies of all sizes. That's been said in Nancy's
21 comments. Nonetheless, there are those who say that scaling
22 the audit means having a different standard for smaller
23 companies. How do we answer that?

24 MS. SALISBURY: To us scaling is not trying to have
25 a different standard for different companies. It's more

1 about allowing an auditor to be able to recognize that there
2 are different facts and circumstances at each particular
3 company and that you aren't going to be able to use a one
4 approach fits all when you are trying to evaluate the
5 effectiveness of internal control.

6 The manager of a smaller company is certainly going
7 to have a very different knowledge of their financial
8 reporting process based on their daily involvement with that
9 company than the CFO of a Fortune 500 company. And so that
10 can and should result in a different internal control
11 structure at the smaller company. The audit standard needs
12 to, in order to be appropriately scalable, needs to allow the
13 auditor to recognize that there will be that difference and
14 to allow them to perform their audit taking that difference
15 into consideration.

16 COMMISSIONER CAMPOS: And that is not creating a
17 separate standard?

18 MS. SALISBURY: That's not creating a separate
19 standard. That's allowing an auditor to recognize what's
20 there rather than forcing everybody to create a control
21 system that works to an audit standard.

22 MS. PALMROSE: I think a better way to look at it
23 is it's an auditing tool that the auditor can use in trying
24 to determine what to audit as opposed to a standard.

25 COMMISSIONER CAMPOS: Well, again, these terms are

1 out there in the world and I think it's incumbent on us and the
2 staff to be very clear about what we mean and to protect
3 against misinterpretations of this term as well as our
4 earlier discussion about judgment.

5 Let me also note that many point out that most of
6 the companies in the U.S. are under this definition of
7 smaller companies. The vast preponderance of percentage of
8 public companies are smaller companies that fit this.
9 Therefore, many point out that most of the fraud and
10 restatements that we see, and in particular many of the
11 blatant frauds, stem from smaller companies.

12 So that said, again, how do we answer that a scaled
13 audit does not somehow allow that to occur? And is the
14 answer that a scaled audit does not mean a less rigorous and
15 effective audit?

16 MS. PALMROSE: That's exactly right. Remember, the
17 objectives of both are the same. So that's the key. The
18 standard provides that you are getting to the same place for
19 companies of all sizes.

20 And I think it, again, this goes back to something
21 that we talked about a little bit earlier, but here again the
22 staff thinks it is very important to think in terms of an
23 integrated audit. And that the financial statement audit
24 actually can inform the control audit in a very productive
25 fashion and vice versa.

1 And some of these risks that you're assessing that
2 you're talking about in terms of the fraudulent financial
3 reporting risk do have root in terms of the control
4 environment and those are things that we talk
5 about in Management Guidance and that we put on emphasis on
6 that auditors need to consider, too.

7 Some of them are necessary, but not sufficient,
8 conditions that's for sure, but all of those are an important
9 element of the risk assessment process for companies of all
10 sizes in an integrated audit context.

11 COMMISSIONER CAMPOS: It seems to me that another
12 way of saying much of what you're talking about is that sort
13 of a non-thinking, busy work approach does not necessarily
14 allow you to focus on risks and materiality and can be just
15 as dangerous if it's too prescriptive.

16 MS. PALMROSE: That's exactly right. And I think
17 Jeff Steinhoff again used terms that are very salient here
18 which include knowledge, expertise of the people making the
19 judgments as well as professional skepticism, healthy
20 skepticism. And all of those come from good -- make good
21 judgments. They don't come from checklists.

22 COMMISSIONER CAMPOS: And focus. Also, just one
23 last point here on this matter, is it your view, the staff's
24 view, that scaling should be focused not just on size but also
25 the complexity and the particular characteristics of a

1 company?

2 MS. PALMROSE: The answer is facts and circumstances
3 would include both of those elements. So, again, complexity
4 is a term that it's important to think of in the context we're
5 talking about here. Some control systems are more complex
6 than others and we are really talking about the complexity of
7 the control system.

8 And you can have a company that has complex
9 elements to its control system and yet have simple
10 controls in other areas.

11 COMMISSIONER CAMPOS: And be small.

12 MS. PALMROSE: And be small, yes. You can actually
13 have large companies, too, that have complex control systems
14 in some areas and simpler controls in others. So those are
15 characteristics that are important to consider as factors
16 that relate to the risks of financial misstatement in the
17 context of those control elements.

18 MS. STACEY: And I agree with Zoe-Vonna. I mean size
19 is just one of the indicators of how you're scoping your audit.
20 The Advisory Committee on Smaller Public Companies pointed out
21 that, you know, smaller companies tend to have less complex
22 systems. They tend to be simpler with financial reporting.
23 But there are also some that we have seen that are much
24 larger. They have large market caps but they have a very
25 simple business model. And so for that instance, size really

1 doesn't matter because they are very similar to some of these
2 smaller companies. So, while size is a very important
3 indicator, there are others and complexity can be one of
4 them. But there are also companies who are very simple
5 except they have one very complex transaction and that
6 doesn't necessarily make them complex. So it is one of the
7 indicators, but there are several others.

8 COMMISSIONER CAMPOS: Yes. Well, thank you very
9 much. I appreciate all those answers.

10 CHAIRMAN COX: Commissioner Nazareth.

11 COMMISSIONER NAZARETH: Thank you. You have
12 answered most of my questions. I really only have one. The
13 staff is suggesting that, in your remarks, that there not be
14 unnecessary conditions on the applicability of the scaling
15 concepts. What did you mean by that term, "unnecessary
16 conditions?"

17 MS. SALISBURY: Well, it goes back to the size and
18 complexity conditions that are currently built in. The
19 proposed standard set up the section to be structured around
20 considerations that could be given for companies that were
21 smaller in size and less complex. And, as we've discussed
22 throughout this discussion this morning, you know, you really
23 have to take into consideration the full facts and
24 circumstances of the company's situation rather than trying
25 to limit it by, you know, purely their size or what you might

1 consider their complexities.

2 As Carol said, you might have complex transactions
3 in one area but the rest of your business model will be very
4 simple. So we wanted to make sure that the standard provides
5 flexibility, if the auditor has the ability to use those
6 considerations and those principles in all appropriate
7 situations.

8 MS. STACEY: And there are also some commenters who
9 commented that they thought that just documenting size and
10 complexity requirements would complicate things and would
11 cause a lot of additional work that was unnecessary. So
12 there was also the documentation question that came into
13 play.

14 COMMISSIONER NAZARETH: Is what you're suggesting
15 then that even within a company you can have different
16 techniques being used based on whether or not, for instance,
17 one division is involved in derivatives or some sort of
18 complex business and other parts of the business are less
19 esoteric.

20 MS. STACEY: Absolutely.

21 MS. PALMROSE: In other words, it's not a binary for
22 a company. It's not a 0-1 on a company basis. So it really
23 is trying to capture facts and circumstances and just using
24 the term "complexity" to, you know, as a substitute in some
25 sense for facts and circumstances in this context.

1 COMMISSIONER NAZARETH: Thank you.

2 CHAIRMAN COX: Commissioner Casey?

3 COMMISSIONER CASEY: I just wanted to follow on to
4 some of the questions which touched on the comments that we
5 received particularly from small businesses. And I know that
6 there was some question about the clarity associated with the
7 scaling guidance and that in general I understand that the
8 belief was that it was relevant but that there was some
9 desire for additional guidance which the Chairman's comments
10 touched on.

11 Can you talk about what the comments said in terms
12 of some of the attributes? Whether they felt the attributes
13 that were identified in the guidance were sufficient?
14 Whether there were additional topics that had to be included
15 or that should be considered being included? Just a little
16 bit of a flavor on the comments that we received.

17 MS. SALISBURY: I'm trying to remember. I don't
18 think we had very extensive comments on the attributes
19 themselves. The comments were generally in favor of what the
20 PCAOB had outlined -- I think it was six or seven.

21 Brian, do you --

22 MR. CROTEAU: I think that's right. There were some
23 comments around considering integration of the audit and how
24 the financial statement audits integrated and whether that
25 attribute should be considered as well. But I think to

1 Nancy's point, the commenters for the most part were more
2 concerned with how to apply the attributes.

3 MS. STACEY: And I think it was also -- there were
4 some comments around the complexity issue and the fact that,
5 you know, what I pointed out before, if you have one
6 transaction that's complex, does that just make you no longer
7 able to apply a scalability concept. The auditors
8 would have to look at it as if you're not
9 really a small company and couldn't tailor to what the
10 company actually has in their internal control system.

11 So that was another area that was commented
12 on was how does complexity impact scalability. And this is
13 definitely something that we got a few comments on.

14 CHAIRMAN COX: Thank you. Is there further
15 discussion on this part of it?

16 (No response.)

17 CHAIRMAN COX: If not, I will summarize the staff's
18 recommendation on scalability and ask the Commissioners to
19 express agreement for or disagreement with this approach.

20 Specifically, the SEC staff proposes to work with
21 the PCAOB staff first to extend scaling concepts throughout
22 AS5, to tailor the audit to the control systems of smaller
23 companies rather than requiring smaller companies to conform
24 their appropriately tailored control systems to the auditing
25 standard.

1 Second, to ensure the appropriate integration of
2 the financial statement audit in the auditor's consideration
3 of the tests necessary for the internal control audit.

4 And, third, to ensure the applicability of scaling
5 concepts without unnecessary conditions, focusing on the
6 facts and circumstances of each company.

7 Do the Commissioners support the staff's approach?

8 COMMISSIONER ATKINS: Aye.

9 COMMISSIONER CAMPOS: Yes.

10 COMMISSIONER NAZARETH: Yes.

11 COMMISSIONER CASEY: Yes.

12 CHAIRMAN COX: Yes.

13 And that recommendation is agreed to. We will now
14 go on to the third recommendation concerning the auditor's
15 ability to exercise judgment.

16 MS. PALMROSE: Thank you. The third issue we would
17 like to address with the Commission today relates to the
18 auditor's ability to exercise judgment as was just noted
19 based on the circumstances of the individual audit engagement
20 to determine the audit procedures and testing required to
21 support the opinion on ICFR.

22 Brian Croteau will briefly describe the concerns
23 raised by the commenters and possible suggestions for
24 improvement. And following Brian's remarks, the staff of OCA
25 and Corp Fin will once again be happy to discuss any of your

1 questions.

2 MR. CROTEAU: Thank you, Zoe-Vonna.

3 There are two issues raised in the comment letters
4 that we would like to discuss further with you today related
5 to the auditor's ability to exercise judgment to determine
6 the amount of testing to obtain sufficient audit evidence.

7 First, numerous comment letters raised the concern
8 that the proposed auditing standard is not clear as to how and
9 to what extent the amount of testing can be meaningfully
10 altered based upon the auditor's risk assessment.

11 For example, a number of comment letters were
12 concerned that the lack of clarity in this area, especially
13 when combined with prescriptiveness throughout the proposed
14 auditing standard may prevent auditors from taking full
15 advantage of the risk-based approach in auditing internal
16 control over financial reporting.

17 In addition, there were mixed views from the
18 comment process about whether the proposed auditing standard
19 should permit rotational testing particularly in lower risk
20 areas which the auditor has sufficient knowledge that the
21 process and related controls are unchanged from the prior audit.

22 Further, a number of comment letters raised
23 questions about the impact of entity level controls and other
24 monitoring and evaluation activities of management on the
25 nature and extent of audit evidence.

1 In order to address these issues, it would be
2 helpful for the proposed auditing standard to clearly and
3 directly describe how the auditor makes use of its own risk
4 assessment and of the monitoring and evaluation activities
5 conducted by company management to determine the amount of
6 testing.

7 The staff believes that the proposed auditing
8 standard should indicate that decisions regarding
9 sufficiency of the evidence should be based on the results of
10 the auditor's risk assessment. This would include allowing
11 the auditor to conclude for a given control, or a series of
12 controls, that evidence obtained through the auditor's risk
13 assessment activities, management's monitoring activities and
14 evidence obtained through a walk-through procedure are
15 appropriate in lower risk circumstances.

16 The second area we would like to discuss involves
17 significant deficiencies in the related auditor
18 responsibilities. The proposed standard states that auditors
19 are not required to search for control deficiencies that
20 individually or in combination are less severe than material
21 weaknesses. However, it does require auditors to evaluate
22 whether control deficiencies are significant deficiencies and
23 if so communicate them to the audit committee.

24 We have heard feedback that this communication
25 responsibility may be inappropriately affecting the level of

1 audit scoping.

2 To address these concerns the staff believes that
3 the auditing standard should be reconsidered to recognize new
4 communication requirements related to these matters that have
5 occurred under the Sarbanes-Oxley Act.

6 For example, under the provisions of Section 302 of
7 the Sarbanes-Oxley Act and the SEC's implementing rules,
8 management's top officers must certify that they have
9 communicated matters relating to significant deficiencies and
10 material weaknesses to the audit committee. Therefore, we
11 would like to explore with the PCAOB staff ways to provide
12 for proactive auditor communication with the audit committee
13 that builds upon rather than duplicates the existing
14 management communication requirements, especially if the
15 auditor communication requirement could inappropriately
16 affect the level of audit scoping.

17 The staff believes that these modifications might
18 have potential to reduce misunderstandings about the scoping
19 of the audit and positively affect the level and amount of
20 testing without decreasing or limiting the totality of the
21 information received by the audit committee about the
22 condition of a company's internal controls.

23 The Commission staff proposes to work with the
24 PCAOB staff on the following three suggestions. First, to
25 ensure that the auditor has latitude to establish the level

1 of evidence required based on the auditor's assessment of
2 risk.

3 And, second, to ensure that the auditor can make
4 appropriate use of management's risk assessment and monitoring
5 activities in determining the auditing procedures.

6 And, third, to explore the relationship between the
7 auditor's communications of significant deficiencies and
8 management's responsibilities in this area.

9 This concludes the remarks in this area and we are
10 happy to answer any questions that you have.

11 CHAIRMAN COX: Thank you very much. This is
12 another area where I think we need to dive into it a little bit
13 because it seems that everybody is in agreement -- we have
14 raging agreement between the SEC and the PCAOB about the
15 importance of auditors using their judgment. So why are we
16 still focused in this area?

17 MR. CROTEAU: I think the reason we're focused on
18 this area is that the comment letters reflected that the
19 standard, as proposed, may not be sufficiently clear about
20 the latitude that the auditor has in making decisions
21 about the extent of testing.

22 And so what we would like to do is work with the
23 PCAOB staff to help make sure that the standard does
24 articulate this so auditors can actually exercise this --

25 CHAIRMAN COX: Is that another way of saying we

1 know what we're talking about but the people who are reading
2 it don't seem to understand it?

3 MR. CROTEAU: Well, I think what they would
4 like is just clarity within the standard. I think
5 even in the Board's release there was some description,
6 but they would like to have some clarity in the
7 standard to be sure that we are all talking about the
8 same thing.

9 CHAIRMAN COX: Does anybody else have any further
10 thoughts on that one?

11 MS. PALMROSE: I think it is important that we do
12 decide that we all are talking about the same thing, too.
13 There are going to be some areas in this related to this
14 issue where the comment letters make clear that we are not
15 all talking about the same thing. And so those are things
16 that we will be sorting through, too, with the PCAOB.

17 CHAIRMAN COX: All right. Just one other question.
18 Can you lay out a bit more elaborately what you mean by the
19 auditor's risk assessment and how that's going to impact the
20 auditor's procedures and testing under the recommendation
21 you're putting forward today?

22 MR. CROTEAU: Sure. Yes. As you know, the proposed
23 standard does indicate that as risk associated with the
24 control being tested decreases, the level of evidence the
25 auditor needs to obtain decreases. And as the risk associated

1 with the control being tested increases, the level of evidence
2 the auditor needs to obtain increases.

3 The staff thinks that additional principles-based
4 guidance would be helpful to help auditors understand how risk
5 meaningfully impacts their testing. And when I'm talking about the
6 auditor's risk assessment, what I'm referring to are the considerations
7 that the auditor makes around matters such as the nature and
8 materiality of the misstatements the controls are intended to
9 prevent or detect, susceptibility of misstatement, change in
10 volume or nature of the transactions and the like. It's those
11 types of considerations that the auditors make with respect to
12 their risk assessments that we want to be sure that auditors then
13 understand how they can factor that into decision about the
14 nature, timing, and extent of their work.

15 In Management Guidance, we gave examples
16 of what companies may do in lower risk areas
17 in relying on their ongoing monitoring versus the
18 direct testing we would expect in the higher risk areas.
19 That is the sort of link that we're expecting to
20 talk through with the PCAOB staff.

21

22 MR. HEWITT: I just might add, the risk
23 assessment by the auditor is extremely important as to their
24 scope of their audit. However, they must or should discuss
25 their risk assessment with the audit committee so that the

1 audit committee understands what the auditor considers as
2 risk, high risk especially within the company.

3 CHAIRMAN COX: Thank you for that.

4 Brian, do you have anything else?

5 MR. CROTEAU: No.

6 CHAIRMAN COX: Okay. Commissioner Atkins?

7 COMMISSIONER ATKINS: Thanks, Mr. Chairman.

8 This again is obviously another very crucial aspect
9 of the whole thing that needs to be addressed and
10 particularly in my view with respect to significant
11 deficiencies because that's one thing that I have heard over
12 and over in my discussions and travels that seems to be
13 useless wheel-spin. And I know that that is a significant
14 change from AS2 to AS5 in that regard and we have sort of
15 -- I know the PCAOB has tried to inject more judgment into
16 the whole determination of what a significant deficiency is.

17 I guess my question for you is how would your
18 recommended approach help to direct the auditors'
19 identification or their work more towards identification of
20 material weaknesses than to significant deficiencies. And
21 just by this very fact of this nomenclature that's new to
22 this whole 404 regime, significant deficiency, we sort of
23 come in a way full circle from the concept in AS2
24 now to more judgment which is much more of the old reportable
25 condition concept. Shouldn't we just do away with

1 significant deficiency and focus on having the
2 accountants report reportable conditions to the board, to the
3 board of directors, to the audit committee as they have been
4 want to do for many, many years rather than having this, this
5 sort of artificial determination that goes up to the national
6 office and then back and there's all this incredible amount
7 of work and added expense which adds to the -- it is in the
8 pecuniary interests of the auditors perhaps but not perhaps
9 the investors' interests.

10 MS. STACEY: You're right, Commissioner Atkins, it
11 does go back to the financial audit before internal
12 control was added when the auditor had the responsibility to
13 determine what should go to the audit committee, and the old
14 audit standard on that or the interim audit standard called
15 those reportable conditions.

16 The auditors still had the ability in that standard
17 to use their judgment as to what would go to the audit
18 committee, so it wasn't necessarily every de facto reportable
19 condition would go, but the auditor did have a judgment to
20 play in that one.

21 Now, what we think is probably important especially
22 if significant deficiencies are potentially impacting the
23 scoping of the audit is to just remove that totally from the
24 auditor. Sarbanes-Oxley gave management the responsibility
25 to communicate to the audit committee the significant

1 deficiencies.

2 Now, the auditors have a very important role in
3 that they need to understand what management has brought
4 to the audit committee. We are trying to get them away from
5 the mindset of looking at every deficiency and saying is it a
6 significant deficiency that needs to be brought. But rather
7 have them step back and look at the totality of the
8 deficiencies that they have and say, "Which ones are
9 important enough for me to discuss with the audit committee.
10 I don't care if management reported them or not. I need to
11 talk to the audit committee about them."

12 Obviously, if they think management should have
13 brought one to them and didn't, that is a different type of
14 conversation to have with the audit committee.

15 But we thought it was more important in stepping
16 back and thinking about this, Sarbanes-Oxley obviously put
17 the role on management to report significant deficiencies, so
18 what role can the auditor play? The auditor really should be
19 playing the role of, "Audit committee, these are the ones
20 that concern us and we want to bring them to you."
21 Irrespective of whether management called them a significant
22 deficiency to begin with.

23 COMMISSIONER ATKINS: Yes, I agree. I just think
24 the artificial construct of it is really debilitating in this
25 whole context.

1 MR. WHITE: I think it is important to
2 recognize that we are suggesting looking at AS5 in this
3 respect in terms of the existing literature which I guess is
4 often AU325 or somewhere like that, some technical place,
5 that you've been referring to.

6 We are not suggesting that that be changed.

7 COMMISSIONER ATKINS: Right.

8 MR. WHITE: That we should be staying with the
9 system where if an auditor thinks there are important matters
10 that ought to be brought before the audit committee that they
11 will continue to do that.

12 COMMISSIONER ATKINS: Right.

13 MR. WHITE: SOX 302 doesn't replace that.

14 COMMISSIONER ATKINS: Right. But I think it's
15 this artificial identification of is this a "significant
16 deficiency," or not that creates an incredible amount
17 of needless work I think. And so that's what needs to
18 be addressed in my opinion. So I'm glad you're on the
19 case on that.

20 And with respect to the materiality concept that
21 you were talking about, how can we incorporate materiality
22 better into the scoping process? I mean because like you all
23 were saying that's -- up front that's a very crucial step for
24 the auditor to take in determining what sort of work from a
25 risk-based perspective he's going to be doing. I'm just

1 curious if you had any particulars in that.

2 MR. CROTEAU: I'll start and Zoe-Vonna may add. But
3 certainly the auditors' risk assessments and their decisions
4 in scoping are to be based on materiality and those are to
5 impact the work throughout the entire process in the audit
6 standard. And I think, again, emphasizing that in the
7 standard is important which the PCAOB has done in the
8 proposal.

9 MS. PALMROSE: Let me just add that they've tried to
10 provide some language to focus on what really matters here in
11 terms of the determination of materiality. But we are also
12 going to look at the comment letters in this regard to see if
13 there is any suggestions for improvements in this area, too.

14 It is a key driver here and materiality is what
15 matters. And so it's important to get that guidance right.

16 COMMISSIONER ATKINS: Right. As we discussed the
17 other day, there's a big difference in a prospective versus a
18 retrospective materiality determination, but I think better
19 guidance in this area would be very helpful for everybody
20 involved. Thanks.

21 CHAIRMAN COX: Commissioner Campos.

22 COMMISSIONER CAMPOS: Thank you.

23 In theory, the idea of allowing auditors to vary
24 the level of testing according to the risk assessments seems
25 very logical and rational. That said, I am aware that there

1 is skepticism or concern in various quarters that when done
2 in total this process of using reduced or at least the
3 flexibility to have reduced testing will lead to gaps in
4 testing with respect to individual controls or groups of
5 controls.

6 For example, we're suggesting that the audit be
7 less prescriptive, allow for greater scalability, permit
8 rotational testing in certain circumstances, be more
9 principles-based in determining the competency and objective
10 of others.

11 Taken together, is it possible that all of these
12 things will lead to a gap in a particularly important control
13 or worse yet, lead to no testing?

14 MR. CROTEAU: Let me start with that and maybe just
15 to clarify starting with the comment on rotational testing
16 and then thinking about the totality of it.

17 We learned from the comment letter process that
18 there are mixed views not only about whether rotational
19 testing should be allowed but also what it exactly means.
20 And the staff does suggest that the auditing standard provide
21 latitude, as you've mentioned, for auditors to consider all
22 information available to them to vary the nature, timing and
23 extent of their testimony. Some view that as a form of
24 rotation.

25 Some also view rotation to be rotating out some

1 portions of ICFR in some years so that they are not testing
2 some controls at all or considering those controls at all in a
3 given year. The staff does not support incorporating
4 rotational testing in the standard in that sense.

5 The staff does believe that an audit opinion on an
6 internal control over financial reporting should require the
7 auditor to consider all aspects of ICFR each time an opinion
8 is issued.

9 We believe it might be confusing to investors to
10 have an opinion where some controls were not looked at simply
11 because they were rotated out that year. And so going back
12 to some of the remarks in the introduction that I made, it is
13 a matter of being able to have latitude to adjust the amount
14 of work, and consider the auditor's risk assessment,
15 management's monitoring activities and a walk-through,
16 and considering whether in lower risk areas that may
17 be enough testing. But we are not prescribing taking or
18 suggesting that we talk to the PCAOB staff about taking
19 controls completely off the table from consideration within a
20 given year.

21 And so I think just from a rotational perspective
22 that's important to have that as a starting point for the
23 discussion.

24 In terms of your broader comment on the totality of
25 all of these considerations, the auditor still needs to

1 obtain sufficient competent evidence and be able to issue an
2 opinion that provides reasonable assurance. And so we are
3 not asking the auditor to take things off the table that
4 prevent them from doing that.

5 Again, we are trying to provide the auditor with
6 sufficient latitude to exercise professional judgment and
7 really focus on the areas of higher risk as they believe
8 appropriate.

9 COMMISSIONER CAMPOS: Let's bore down a little bit.
10 In a given year when internal controls are being reviewed by
11 auditors, the high-risk controls I take it under our thinking,
12 and this, of course, has to be discussed and worked out, but
13 under our thinking, what would happen to high risk controls
14 in a given audit?

15 MR. CROTEAU: Higher risk controls would be subject
16 to a greater extent of testing so presumably a larger sample
17 size of the operation of that control from an operational
18 perspective. All controls would be looked at from a design
19 perspective. When I say all controls, I mean all controls
20 important to the auditor's conclusion. So those controls
21 that the auditor determined were necessary to provide
22 reasonable assurance about whether the company's controls
23 sufficiently address the risk of a material
24 misstatement.

25 So, for the higher risk controls, auditors would

1 test more operations of the controls for operating
2 effectiveness as compared to the work you might do on lower
3 risk controls which would have a lower sample size or perhaps
4 the auditor relying on a walk-through of the control.

5 COMMISSIONER CAMPOS: Right. So a lot of the
6 flexibility that you were considering and want to discuss
7 with the PCAOB staff really comes to bear on lower risk
8 controls. Isn't that a fair summary?

9 MR. CROTEAU: Yes. I think that's fair. In
10 the higher risk areas we would expect the auditor to do more
11 work and continue to do that work in future years. It is
12 what you do with the lower risk controls and how you can
13 modify your work from year to year that we're talking
14 about from that perspective.

15 COMMISSIONER CAMPOS: Right. And, again, it seems
16 to be very critical just to -- if I'm repetitive, it's
17 because I just think it's so important -- to get to the end
18 result of an auditor's assessment and attestation opinion,
19 the auditor has to look and have enough evidence, as you
20 said, right?

21 MR. CROTEAU: Yes.

22 COMMISSIONER CAMPOS: To test or to at least
23 evaluate the workings of all of the controls. Is that
24 correct?

25 MR. CROTEAU: Yes, the auditor has to have sufficient

1 competent evidence to support their opinion, yes.

2 COMMISSIONER CAMPOS: So when people say, "Well,
3 gee, all of this is going to result in gaps or no testing,"
4 that isn't what we at least -- we being the staff and what
5 you're suggesting -- that doesn't seem to be consistent.
6 Does it? Because there is not a skipping, if you will, or
7 letting a test not be looked at through rotational
8 principles or anything? Is that right?

9 MR. CROTEAU: Right. It's the idea of providing
10 latitude to vary the nature, time, and extent of testing.

11 MS. PALMROSE: Can I just add that this is a concept
12 that is long-standing in the financial statement audit. So
13 it is interesting that we are having so much dialogue around
14 it in this context when these are sort of well accepted
15 notions in the financial statement audit.

16 And, again, it would help if we talked about
17 it in the integrated audit context, too, and each
18 informing the other and actually getting a better risk
19 assessment and testing then based on an appropriate
20 risk assessment for both.

21 COMMISSIONER CAMPOS: Yes. And, again, this goes
22 back to my repetitive theme that I think these are not
23 concepts that are necessarily grasped by large groups of
24 players in the system. I think it is incumbent on all of us
25 to make sure we are very clear about what we mean and there

1 is an educational component here that I hope we take on.

2 MS. PALMROSE: I suspect very few people who are
3 discussing or a number of people who are discussing these
4 never anticipated that they would be having these kinds of
5 discussions. So we appreciate that. But it is important.
6 It actually helps clarify one's thinking, you know, as part
7 of the education process. We very much appreciate being able
8 to do that.

9 COMMISSIONER CAMPOS: Good. I'm almost done.

10 Jeff Steinhoff made the point and I think I've
11 heard it through other commentary today about professional
12 skepticism being critical. Do we plan to stress that in any
13 way or make sure that doesn't get lost in the wash?

14 MS. PALMROSE: Let me say a few things about this
15 because I feel very strongly. I was involved in the task
16 force that helped draft SAS 99 which is the fraud standard.
17 And it was something that we spent a great deal of time on
18 because we thought it was absolutely essential.

19 And one of the things you think about in terms of
20 professional skepticism is the importance of recognizing
21 disconfirming evidence. Not just confirming evidence. And
22 so that standard recognized and built in considerations that
23 we hoped would help with that mindset.

24 Having said that, one of the things that Jeff
25 alluded to but we haven't talked at all about is when it

1 comes to fraudulent financial reporting is the risk of
2 management override in particular.

3 In other words, you can have a gold-plated control
4 system and you still have some risk of management override.
5 It's sort of the elephant in the room or the Achilles's heal,
6 however you want to describe it.

7 So, again, I think I've said this maybe one too
8 many times, but it is important to think about the integrated
9 audit because the risk of management override gets considered
10 from both the ICFR perspective as well as the financial
11 statement perspective.

12 COMMISSIONER CAMPOS: So somebody will see that
13 elephant.

14 MS. PALMROSE: Well, it's a very important one.
15 It's a very important one to address.

16 COMMISSIONER CAMPOS: Sure.

17 MS. PALMROSE: And frankly the audit committee has
18 an important responsibility in that regard, too. So it's
19 something that in the post SOX environment I think a number
20 of constituents are stepping up to the plate and recognizing
21 the importance of it.

22 COMMISSIONER CAMPOS: Thank you very much.

23 CHAIRMAN COX: I think we can all agree that
24 management override is the Achilles's heel on the elephant
25 in the room.

1 Commissioner Nazareth.

2 COMMISSIONER NAZARETH: Thank you.

3 I just wanted to turn back for one moment to this
4 issue of the term, "significant deficiency," in AS5. My
5 understanding is that by using the term and the way it comes
6 into the auditing standard it has had the perhaps unintended
7 consequence of causing auditors to expand the scope of the
8 audit. Because it's in there, the expectation is if they
9 find deficiencies, now they have got to do enough work to
10 figure out if they are significant deficiencies as the
11 defined term goes and follow the process from there.
12 And that that perhaps wasn't intended.

13 On the other hand, I guess it is clearly important
14 that management and audit committees are aware of
15 significant deficiencies or reportable conditions or
16 whatever we call them. And so it does seem to me to
17 be important that in fine-tuning AS5 that we not do
18 anything that has a chilling effect on the benefits that come
19 from that kind of communication.

20 So could you again, because I'm not sure I
21 completely understood your answer, could you again describe
22 how the current accounting literature works and what we would
23 do to the current literature to ensure that we get both the
24 benefits of, you know, not having the scope of these audits
25 expand unnecessarily but at the same time having a robust

1 dialogue with audit committees on these important issues?

2 MS. PALMROSE: Maybe I could start out and then
3 Carol, do you want to jump in here and maybe elaborate?

4 First of all, I think it is extremely important to
5 recognize that the audit committee needs this information.
6 And so there is no expectation to reduce the information set
7 that the audit committee has or dialogue around the quality
8 of that information set in terms of control deficiencies and
9 the degree to which they are important or not.

10 Another element of it is that it's important to
11 have the dialogue around what's a material weakness and not
12 get caught up in an artificial classification between
13 significant deficiencies and material weaknesses.

14 In other words, there is some comfort -- there is
15 actually maybe personal concern that you can take comfort in
16 you have got them classified as a significant deficiency
17 rather than a material weakness because at least they have
18 gone to the audit committee then.

19 And it is really important to not allow that to
20 happen because the material weaknesses are getting
21 communicated to investors and we don't want those
22 undermined by the notion that, well, as long as the audit
23 committee has it that's what counts.

24 So within that context it has caused us -- in some
25 of the comment letters, there's not I don't think a large

1 number on this. I think it's a fairly small number, but it
2 has caused us to sort of rethink this area. And that's what
3 Carol was alluding to here in terms of the existing
4 requirement outside of AS5 for communications on
5 these. And the question is does it have to be within
6 the context of AS5.

7

8 We already have a standard, a different standard on
9 communications with audit committees over a number of
10 dimensions that don't now include the control communication
11 within that standard.

12 We also have another standard that has interim
13 reviews that has a control communication to it, too. So what
14 the staff is suggesting that maybe now is an opportune time
15 to relook at the existing auditing literature, see where
16 these communications are embedded in that literature, look at
17 what's now changed post SOX in terms of the required
18 communications with management and sync them up so that
19 everybody is getting the information they need and also
20 getting it in the form and substance of the way they need it
21 and have the proper dialogue around it. So that's the idea.

22 Now, whether there will be any changes or not, I
23 don't know, but at least we want to have the dialogue.

24 COMMISSIONER NAZARETH: Right. And I think that
25 makes sense. I guess the other concern that some might raise

1 that we need to be conscious of is whether or not if through
2 this process we end up having the auditors only communicate
3 the information to management ensuring that there's no break
4 between management and the audit committee in having that
5 communication occur. I think that certainly some
6 commentators will say, "Well, at least this way you knew that
7 it was going to happen because the auditor was going to do
8 it."

9 So again we have to be conscious of not losing the
10 quality of the communication.

11 MS. PALMROSE: Exactly. In other words, it is not a
12 retrenchment on anything that's occurring or that should
13 occur, it is simply a rationalization of our rules and
14 standards.

15 MS. STACEY: Yes, I mean obviously when management
16 is presenting the list of significant deficiencies to the
17 audit committee, they have already talked to the auditor
18 about those. So presumably if there is some disagreement or
19 the auditor believes that there is something that may not be
20 a significant deficiency but is well worth the audit
21 committee knowing about, this would just open the lines of
22 communication we think for the audit committee and the
23 auditor to have a frank discussion over not just what's on
24 management's list but what isn't.

25 And so I think -- we think that this approach

1 eliminates that bright line test, is it a significant
2 deficiency or not, eliminates the potential scuffles back and
3 forth between management and the auditor over what is and is
4 not on the list. Potentially eliminates the scoping issues
5 but still leaves the auditor with the professional
6 responsibility to discuss with the audit committee any
7 deficiencies that concern them that they believe the audit
8 committee should be aware of.

9 MR. WHITE: I mean I think it's important to realize
10 that you can have deficiencies that the management may not be
11 as likely to identify. I mean the one that I think is most
12 common is where management lacks the experience or knowledge
13 or background in applying GAAP, for example. I mean they may
14 not be as quick to pick that up and report that. And so
15 there are certainly situations where we're very
16 much relying on the auditors to bring deficiencies,
17 however we define them, to the attention of the audit
18 committee.

19 MS. PALMROSE: I don't want to prolong this, but I
20 just wanted to maybe add one more useful thought and that is
21 that we are also looking in the context of management
22 guidance where we might be able to provide some more dialogue
23 or structure in Management Guidance to backfill on any issues
24 here that might arise that would address your concerns, too.
25 So, we are also looking at it in that context.

1 COMMISSIONER NAZARETH: Thank you.

2 CHAIRMAN COX: Commissioner Casey.

3 COMMISSIONER CASEY: I'd like to go back to some of
4 the earlier comments regarding the sufficiency of walk-
5 throughs in testing. I know there was a lot of commentary
6 about when it might be appropriate to just conduct a walk-
7 through for testing the operating effectiveness of the
8 internal controls.

9 Similarly, there were also some comments that were
10 raised regarding the ability to rely on others in walking
11 through -- potentially, management I guess and others in the
12 company to assist in those walk-throughs. Could you talk a
13 little bit about the range of comments on that and what
14 circumstances -- high-risk/low-risk circumstances where that
15 sufficiency of the walk-through might apply?

16 MR. CROTEAU: Some of this does get into the next
17 topic, but I'll be glad to sort of tee-up part of it and then
18 maybe we'll cover some of it as well as part of using the
19 work of others.

20 We did have a number of comment letters that raised
21 concerns about the auditors' ability to make use of
22 management's risk assessment and monitoring activities
23 including their self-assessments. And a lot of that had to
24 do with the self-assessments including the review by someone
25 supervisory in nature and concerns of the auditor

1 about that person's objectivity.

2

3 What we are trying to accomplish is a discussion
4 around how management's activities in that area can impact
5 the auditor's work and again providing latitude for that work
6 to be considered in a way that the auditor can adjust their
7 own testing as a result of it.

8 We do understand and appreciate that objectivity
9 is, of course, important. As some commenters have
10 described that work, there is often an element of
11 internal audit involvement on a periodic basis
12 in addition to management's activities.

13

14

15 It is a complex area. It requires auditors to
16 think carefully about what management has done and how it
17 might impact their work, and we would like to have more
18 discussion with the PCAOB on that.

19 COMMISSIONER CASEY: And I know there has been a
20 lot of discussion about the rationalizing of the use of
21 significant deficiency and enhancing the communication to the
22 audit committee and the responsibilities that management has
23 to report significant deficiencies under the law, so I
24 appreciate that clarification of what our efforts would be in
25 discussing this with the PCAOB and enhancing ways to ensure

1 that management does continue to fulfill their obligations.

2 I wanted to ask about a couple of the other issues
3 that were raised along -- some of the concerns associated
4 with the definitions of materiality.

5 I know that there were issues that were raised
6 specifically to some of the strong indications of what a
7 material weakness might be as well as including interim
8 materiality. Could you speak a little bit about those
9 comments?

10 MS. PALMROSE: Yes. I'll start us off and one of
11 the comments or one of the areas in which we did get comments
12 and we realized in advance that we didn't quite sync up with
13 the strong indicators that the PCAOB included in their
14 guidance.

15 And the reason was that we actually thought the one
16 that we left out was an obvious material weakness, not a
17 strong indicator. And, unfortunately, it was interpreted
18 just the opposite. "Did you mean that it wasn't instead of
19 it was?"

20 So we are having dialogue around those and the
21 importance of those within the guidance itself. So that's
22 part of the dialogue that we would like to have. We
23 appreciate that whatever guidance is there would need to be
24 similar now that we obviously got that message that they do
25 need to be similar. But we are revisiting the whole area in

1 terms of the necessity of them and what they say. And,
2 again, the comment letters are helping us inform that.

3 In terms of interim, there is -- this is an area in
4 which there is a lot of I guess I would describe it as angst
5 within both the financial statement audit as well as
6 within the ICFR audit.

7
8 And so we did receive a number of comments about
9 including it or excluding it within the evaluation
10 of potential material weaknesses. And we are considering
11 those. The staff has not reached a conclusion on them. And
12 in all honesty it is -- the staff thinks it is really
13 important to think about the quality of financial reporting
14 on both a quarterly and an annual basis.

15 And, of course, none of the discussion is around
16 controls over quarterly reporting. I mean those need to be
17 in place. The problem here is that in the internal control
18 space you are doing a hypothetical - if you don't
19 have an actual misstatement, you are trying to
20 hypothesize, in other words, you have a hypothetical
21 misstatement that you are trying then to analogize to what
22 the impact would be on quarterly and annual reporting. And
23 that is a hard thing to do. I mean it is hard to make that
24 hypothetical as well as within the context of those two
25 settings.

1 So we appreciate it, but we also appreciate the
2 importance of internal controls for interim and annual
3 financial reporting. And we have no conclusion on this.
4 It is just an area that we have received comment on.
5 The PCAOB solicited comment on it, got a number of comments
6 and we will be talking about it.

7

8 COMMISSIONER CASEY: Thank you.

9 CHAIRMAN COX: Is there any further discussion on
10 this point?

11 (No response.)

12 CHAIRMAN COX: If not, I will summarize the staff's
13 recommendation on use of judgment and ask the Commissioners
14 to express support or disagreement with this approach.

15 Specifically on the use of judgment and testing and
16 evaluation, the SEC staff proposes to work with the PCAOB
17 staff, first, to ensure that the auditor has the latitude to
18 establish the level of evidence required based upon the
19 auditor's assessment of risk.

20 Second, to ensure that the auditor can make
21 appropriate use of management's risk assessment and
22 monitoring activities in determining the audit procedures.

23 And, third, to explore the relationship between the
24 auditor's communications of significant deficiencies and
25 management's responsibilities in this area.

1 Do the Commissioners support the staff's approach?

2 COMMISSIONER ATKINS: Aye.

3 COMMISSIONER CAMPOS: Yes.

4 COMMISSIONER NAZARETH: Yes.

5 COMMISSIONER CASEY: Yes.

6 CHAIRMAN COX: Yes.

7 And the recommendation is agreed to. So now we
8 will turn to the fourth and final of the staff's
9 recommendations, this one concerning using the work of
10 others.

11 MS. PALMROSE: Thank you. Yes, that is our last
12 topic. The PCAOB's proposed auditing standard which is a
13 separate standard related to the use of the work of others.
14 So Josh Jones will briefly describe the concerns raised by
15 the commenters and possible suggestions for responding to them
16 and then we'll be available for your questions.

17 MR. JONES: Thanks, Zoe-Vonna.

18 As background, the PCAOB's interim auditing
19 standards cover the ability of the auditor to use the work of
20 internal auditors for the purposes of the audited financial
21 statements. While Audit Standard Number 2 allows auditors to
22 use the work of internal auditors, other company personnel
23 and third parties working under the direction of management
24 in the audit of internal control, the PCAOB proposed a new
25 audit standard, Considering and Using the Work of Others, in

1 order to provide a single framework for the auditor's use of
2 the work of others in an integrated audit of internal control
3 and the financial statements.

4 The PCAOB's proposed standard provides guidance on
5 the extent to which the auditor can use the work of others
6 based on the competence and objectivity of the party who
7 performed the work. The proposed standard also gives factors
8 that the auditor should consider in making this
9 determination.

10 However, a majority of the accounting firms
11 questioned the need for the PCAOB to replace rather than
12 amend its existing auditing standard related to the use of
13 the work of others.

14 Letters from these firms indicate that the PCAOB's
15 objective of increasing the auditor's use of the work of
16 others can be achieved without a complete rewrite of the
17 existing auditing standard.

18 Further, numerous commenters suggested that the
19 proposal's requirements for evaluating competence and
20 objectivity are unnecessarily rigid and prescriptive and
21 inconsistent with the PCAOB's stated goal of reducing
22 auditor's work in low risk areas.

23 Commenters also raised concerns regarding the
24 restrictions on the auditor's use of management's monitoring
25 activities because in their view it was unlikely that

1 management would ever be deemed objective in accordance with
2 the factors outlined in the proposed auditing standard.

3 These comments raised the possibility that auditors
4 will not be able to consider to an appropriate extent the
5 multitude of activities that a company's management
6 undertakes to monitor and evaluate internal control over
7 financial reporting.

8 Based on our consideration of the comments received
9 to the PCAOB's proposal, we identified several matters that
10 we would like to explore with the PCAOB staff.

11 One involves modifying the rule-based requirements
12 related to assessing competence and objectivity to make them
13 more principles-based with decisions made by auditors in
14 accordance with their judgment about the individual's
15 competence and objectivity.

16 Further, clarifications may be possible to address
17 the circumstances in which the auditor would be able to use
18 management's monitoring activities. The Commission's
19 proposed interpretive guidance enables management to use its
20 own ongoing monitoring activities as evidence to support its
21 assessment.

22 If appropriately designed and operated, monitoring
23 activities might also be a useful source of evidence for
24 auditors and should not be excluded simply because by their
25 very definition the individual performing the monitoring

1 activities is not independent of the underlying control
2 activities.

3 As a result of the concerns raised by the comment
4 letters, we propose to work with the PCAOB staff on the
5 following suggestions.

6 One, to provide principles-based definitions of
7 competence and objectivity that can inform the auditor's
8 judgment of individuals on this basis, and two, to ensure that
9 the auditor can use the work obtained from management's
10 monitoring activities.

11 Thank you. And this concludes the staff's remarks
12 on this issue. We will be happy to answer any questions that
13 you may have.

14 CHAIRMAN COX: Thank you. I want to jump on one
15 aspect of your presentation concerning the requirements for
16 assessing competence and for assessing objectivity and our
17 interest in making that whole approach more principles-based.

18 Since most of the existing audit literature is
19 aimed at audit personnel and since what we are talking about
20 here is providing some guidance on what you do with
21 management who are not audit personnel, is it something of a
22 Procrustean bed to stretch that old audit literature to fit
23 this circumstance? Is that why we need change in this area?

24 MR. JONES: One of the reasons that the staff feels
25 there needed to be changes is that the internal control over

1 financial reporting has fostered the ability of many
2 people within the organization who don't exactly have an
3 audit background or have an internal auditor-like background
4 in their job requirements to perform activities that
5 are or could be very relevant to the assessment of ICFR.

6 And the staff is concerned that, since historically
7 the auditors have been primarily focused on evaluating
8 competence and objectivity as it relates to internal audit
9 personnel, they might have trouble broadening their scope
10 a little bit to consider individuals outside of that
11 department and that fact may unduly influence their ability to
12 utilize work that may actually be very helpful in
13 conducting their assessment in their audit.

14

15

16 CHAIRMAN COX: I appreciate that. Just one other
17 question. Here again we've got agreement in principle I
18 think between the SEC and the PCAOB. In fact, the PCAOB has
19 gone so far as to develop a whole new standard focused on use
20 of the work of others. We obviously both agree that this is
21 very important.

22 Why are you concerned still, why is our staff
23 concerned that even under the proposed new audit standards,
24 both AS5 and AS6, that auditors might not be able to use the
25 work of management?

1 MS. PALMROSE: Let me start off and then maybe Josh
2 would jump in. This is a place where the comment process was
3 enormously informative. And a number of letters from the
4 auditors themselves said that you, PCAOB, you don't need
5 another standard. And this may actually undermine the intent
6 here as written, as drafted. It would undermine the ability
7 to use work of others and expand the universe of these others
8 in the way intended by the PCAOB.

9 So that's our concern is that it doesn't appear
10 that the laudable intent here may have been executed in the
11 way that we had hoped.

12 CHAIRMAN COX: Is this another area where we know
13 what we mean but we're confusing others when we say it?

14 MS. PALMROSE: There is some elements of that here,
15 but it is actually a little bit different problem, too.
16 In expanding the requirements, the proposal is undermining the
17 ability to then use the concepts. Motive and intent are a
18 little bit obscure for me so I won't speak to those. I'll
19 just speak to the result. And that is what we are
20 trying to fix because everybody is trying to get to
21 the same place here. And so the firms' comment letters
22 in this regard were enormously helpful to us.

23 CHAIRMAN COX: Thank you.

24 MS. STACEY: Yes. And some of the comment letters
25 went back to the number of factors that the auditor has to

1 consider when determining objectivity and independence or
2 competence and objectivity.

3 And they have a slight bias according to the
4 commenters and I have to admit I think it is, it is slightly
5 biased towards the internal audit staff. That's obviously
6 who the auditor is used to relying on in the financial
7 statement audit. And, as Josh said, opening that up to other
8 folks in management is a little bit more difficult because
9 you have to consider potentially other factors.

10 And so I think the commenters thought that sort of
11 looking back and determining whether those factors are too
12 prescriptive or too biased towards internal audit would be
13 helpful along those lines. And we do think that that would
14 be helpful, to go back and take a fresh look at how they've
15 structured this and whether the bias is there for internal
16 audit or whether it's possible to open that up to other folks
17 within management.

18 MS. PALMROSE: And using the work of others,
19 remember, is so that the auditor doesn't have to do
20 it him or herself. And if you have to go do more
21 work to assess the objectivity and competence and then
22 document it than it would be to even to just do it
23 yourself, it hasn't accomplished the goal.

24 And there is also a prescriptive ordering here in
25 terms of assessing competence and objectivity and then

1 relevant activities and the firms suggested that it would be
2 more effective and efficient to reverse that ordering.

3 But here again we get caught in the
4 prescriptiveness where you have to do them one
5 after the other, and that turns out probably not to be the
6 most effective or efficient way based on feedback that we've
7 had.

8 So that's why we thought it was also important to
9 reconsider the drafting in this area.

10 CHAIRMAN COX: Well, that certainly makes sense
11 particularly in the lowest risk areas.

12 MR. HEWITT: I would like to add an example to
13 that. Many years ago when I was a teller during my college
14 days, one of fifteen tellers in a bank. We only had
15 two internal auditors in that bank and on a surprise
16 basis two internal auditors would come in and had
17 each of us switch. I would take Susan down there and count
18 her money and balance her cage at the end of the day and
19 someone else would balance mine, and the two internal auditors
20 would supervise the work of this.

21 It could be interpreted under the standard
22 today as proposed that the auditor, the external
23 auditor would have to examine my personnel file to see if I
24 was qualified, and could I count 1 plus 1 and this type of
25 thing. And we don't need that type of thing in today's

1 standard or auditing world. So that is the type of thing
2 that we want to avoid. From a practical viewpoint,
3 the use of management in the internal control
4 audits and testing probably is on a very seldom
5 basis.

6 Smaller companies will have to go outside and
7 outsource and get a local CPA firm to come in and do the
8 testing and that type of thing on a practical basis.

9 CHAIRMAN COX: All right. Thank you.

10 Commissioner Atkins.

11 COMMISSIONER ATKINS: I thank you all. Again, I
12 think this is, from what I've been able to discern out there,
13 a big problem. Obviously, the commenters made some very good
14 comments on it and it was addressed in AS5 and AS2 as
15 proposed.

16 And unfortunately this is where Audit Standard 2
17 basically fed the fires I think of, again, the pecuniary
18 interest of the various auditors in goosing their revenues in
19 order to meet their -- whether it's individual or firm bogeys
20 for revenue. So I think, you know, if we can address this
21 before it gets loosed on smaller public companies, I think it
22 would be better.

23 The GAO did a study where of the 150 companies that
24 they surveyed, 128 actually hired another accounting or
25 consulting firm to help them on Section 404 and for the most

1 part, the accounting firms felt they couldn't use any of that
2 work in their procedures.

3 So I was wondering specifically what changes can be
4 made to these proposed standards to help allow auditors
5 when they deem it appropriate to rely on the work of others,
6 including those who are not, as you were just saying,
7 internal auditors? Do you have anything specific to focus
8 on?

9 MS. PALMROSE: Well, let me start off and say that
10 we actually are taking very seriously the comments, you know,
11 to reconsider the entire landscape here including whether the
12 standard is necessary. And the firms provided some good
13 feedback in terms of how to analyze that question and think
14 about language in the existing standard that might satisfy
15 the requirements here to expand the ability to use the work
16 of others. So, it is -- it is really on the table for the
17 dialogue here in terms of how to get the objective that
18 everybody is trying to get to here.

19 COMMISSIONER ATKINS: Well, I guess even more
20 particularly with smaller public companies where if they have
21 gone out and hired an outside consultant to help them on it,
22 I guess one of the biggest tragedies I think from an
23 investor's perspective, again, that company that I referred
24 to earlier that paid more to outside consultants and its
25 auditors than to put its 404 and financial statements

1 together. Basically when I posed the question directly
2 to the outside auditors whether they had even looked
3 at this nicely put together internal control framework and
4 documentation of the company, they basically said in all
5 candor, "No, we didn't believe that we could under Audit
6 Standard 2." Now, that company poured huge amounts of
7 money into that whole process and for the outside
8 auditors to feel like they could not even look at it even
9 from a scoping perspective I think is a complete outrage from
10 the investor's perspective since this is coming out of the
11 investors pocket. So, I was just curious, how can we
12 remove any unique obstacles with respect to smaller
13 public companies?

14 MS. PALMROSE: Well, I actually think this question
15 gets back to much of what we have been discussing here today
16 in terms of all the other topics. Alignment is a really
17 important one that also enters into the situation it sounds
18 like that you encountered and described.

19 Scaling the audit and the evidence, all three of
20 those along with the use of work of others relate to that
21 topic and if we can address the issues that we've talked
22 about in each of these I think it will go a long way towards
23 not having that situation arise under the revised standards.

24 COMMISSIONER ATKINS: Well, good. That's what I
25 was hoping you would say because we've been addressing these

1 four themes separately; but, just like anything
2 else, the integration of 404 attestation into the financial
3 audit I think is crucial. Part of the problem was that
4 with AS2 and everything else it was taken off as a sort of a
5 separate type of approach rather than an integrated approach.
6 So, hopefully, you know, as we work with the PCAOB to try to
7 get this back on track that we will keep that as our
8 touchstone. Thank you very much.

9 CHAIRMAN COX: Commissioner Campos.

10 COMMISSIONER CAMPOS: Thank you. I admit I'm still
11 thinking about where the heel is on an elephant.

12 MS. PALMROSE: Well, I'm on -- I'm on the Procrust --
13 can't remember what that term was but I couldn't answer the
14 question because I wasn't sure what --

15 COMMISSIONER CAMPOS: I'm just wondering whether an
16 elephant has a heel that we can talk about. Anyway, whether
17 it's Achilles's or otherwise.

18 This has been a good discussion but I feel
19 incompetent because I don't have a story to tell about my
20 company or someplace where I was dealing with some
21 of this stuff.

22 I will try to get into one particular area. It
23 seems to me that the key here is that it's a little bit back
24 to the issue of trust and who can you rely on?

25 So I'm wondering in terms of maybe it's

1 an internal control bias by the audit profession, maybe
2 lawyers -- if lawyers were doing it, they would trust, quote,
3 lawyers more than they would others. So maybe there is a
4 professional bias here.

5 But in terms of reliance on the work of others,
6 what's the element that will break through in terms of
7 figuring out what, when reliance is appropriate. I mean is
8 there one or two touchstones here?

9 MS. PALMROSE: Well, I actually have to start off by
10 saying that it's really important to use the term, "use,"
11 rather than "reliance." So this is a difference with a
12 distinction here where it's using the work of others and the
13 auditor still has to have sufficient competent evidence to
14 reach their own conclusions.

15 And so it is not the same as relying. It is
16 helping utilize that work in reaching that conclusion, but
17 the auditor still has sufficient competent evidence.

18 Now, this occurs again --

19 COMMISSIONER CAMPOS: You realize I'm not used to
20 being lectured to like that --

21 MS. PALMROSE: Oh, I'm so sorry.

22 COMMISSIONER CAMPOS: I'll accept it.

23 MS. PALMROSE: Oh, I'm so sorry.

24 COMMISSIONER CAMPOS: No, no. I can get used to it
25 in a hurry. It's a good point in terms of the reliance. And

1 it's probably something that isn't broadly understood either.

2 MS. PALMROSE: Well, I'm sensitive to it because I
3 misused it two days ago and my wonderful staff corrected me,
4 so it slips into your terminology and, you know, I found that
5 I have to discipline myself here because they are very
6 important distinctions.

7 And it is also important to recognize that these
8 have always occurred naturally again in the financial
9 statement audit and in an integrated audit setting it would
10 occur naturally, too. So in some sense it is not a unique
11 feature either. It's just that in this setting --

12 COMMISSIONER CAMPOS: Okay. So when can the
13 auditor use the work of others?

14 MS. PALMROSE: Well, first of all, when it is
15 appropriate. And so it is thinking about what is the context
16 in which "appropriate" can take place. So it's going to
17 depend upon the risk, it's going to depend upon the nature of
18 the evidence that's needed which is obviously related to the
19 risk also. And it's going to depend upon the characteristics
20 in terms of the reliability of that activity and its
21 relevance for the particular control testing being conducted.

22 So, you know, the competence and objectivity are
23 characteristics that are trying to improve the reliability of
24 that information and, thus, its usefulness for the auditor.
25 But, again, they are correlated with but not perfectly so.

1 So it is thinking about what the first principle is here and
2 what the auditor's task is at hand, And there will be some
3 situations when it's not only not appropriate but obviously
4 not also cost effective to do so. It's trying to identify
5 those situations in which it can occur in a cost effective
6 and relevant way.

7 MR. JONES: And I might add something to that.
8 Another focal point of the staff's recommendation is
9 that the standard right now makes it hard to
10 determine when you can rely on individuals --
11 because it lists a number of considerations that are
12 very specific.

13 And so one of the things that the staff is
14 concerned about is that auditors may have a hard time
15 understanding what kind of continuum there is in terms of
16 what happens when you are dealing with management that
17 might be, for example, mostly competent but maybe less
18 objective, and how the auditor can best determine when
19 to use evidence that they performed as part of the
20 audit.

21 And so one of the things that we're trying to work
22 through with the PCAOB is how to best articulate those
23 principles so that it becomes a little more clear to
24 auditors how they can take the work of management
25 of the company and apply that to their decisions

1 on what evidence they need to gather for the audit.

2 COMMISSIONER CAMPOS: Yes, I think it's nice to
3 know that we have general agreement. It's interesting to see
4 that it's sort of elusive in terms of where you get
5 it down, which is why obviously you've brought it up. And it's
6 an element worth pursuing with the PCAOB staff. And I
7 encourage that some consensus be drawn because I think
8 it will continue to be one of those Achilles heels.
9 It will continue to be a problem as time goes on.

10 So I'm going to essentially end here, but I'm going
11 to end with one observation. And I think that this area,
12 again, speaks to what I view and I think the rest of the
13 Commission views as the approach that is appropriate here
14 with the PCAOB staff in this whole process. In this process,
15 we are partners in trying to figure out how to implement
16 404 as Congress wanted and in a way that's fair to
17 investor protection and in a way that is also fair to issuers
18 and their costs. Thank you.

19 CHAIRMAN COX: Thank you.

20 Commissioner Nazareth.

21 COMMISSIONER NAZARETH: Thanks.

22 Why did the audit firms think that a new audit
23 standard wasn't needed and that simply modifying the existing
24 audit standard would have been preferable? And do you have a
25 view on at this point what is the preferable approach?

1 MR. JONES: Sure. I can take that one. Basically
2 as I talked about briefly, the current guidance related to
3 the auditor's considerations of using the work of others
4 consists of the interim auditing standards which
5 relates primarily to the auditor's consideration of the
6 internal audit function in the audited financial statements
7 and AS2 which relates to the audit of internal control.

8 As we mentioned before, one of the PCAOB's
9 reasons for proposing the standard was to integrate the
10 guidance between the two audits.

11 The firms raised concerns that the current proposed
12 standard may not necessarily provide the appropriate framework
13 to guide the auditor's decisions and that it may actually
14 create additional requirements that do not necessarily
15 add to the overall quality of the audit. And, therefore,
16 they believe that the Board could more effectively
17 accomplish its objectives through minor modifications to the
18 existing interim standards to explicitly allow for its
19 consideration in the audit of internal control.

20 In terms of our position, the staff, right
21 now just wants to discuss the merits of the firms'
22 proposal. But what is really important is that our
23 recommendations are primarily focused around the
24 considerations that are contained in both the interim
25 standards and the PCAOB's proposals. And so ultimately the

1 objectives we're trying to achieve can be accomplished through
2 either way that the PCAOB determines is best to effectively
3 communicate the audit standard.

4 COMMISSIONER NAZARETH: Okay, thank you.

5 CHAIRMAN COX: Thank you.

6 Commissioner Casey?

7 COMMISSIONER CASEY: Well, first of all, I want to
8 again thank you for your response to all the questions that
9 have been asked so far. It has been extremely helpful and as
10 noted many of the different areas that we're talking about
11 definitely apply to each other. And so inasmuch as we are
12 seeking our greater principles-based approach, you get that
13 elusiveness I think that Commissioner Campos talked about
14 which does require more judgment, but I think it makes it
15 more difficult to appreciate, you know, under what
16 circumstances beyond certain factors -- facts and
17 circumstances, as you know, where it would be appropriate to
18 be able to rely on the work of -- or the use -- not "rely".
19 Use the work of others. I apologize.

20 But I want to go back to another point where I
21 think that -- where I think that this will be important and
22 Commissioner Atkins spoke to this. The GAO's work earlier
23 back in April of 2006 to the Congress on Sarbanes-Oxley spoke
24 about the particular kinds of considerations that you should
25 think about in terms of the adverse costs for smaller

1 companies versus larger companies.

2 And certainly giving consideration to the unique
3 circumstances or characteristics of smaller companies which,
4 because of resource limitations, adversely affect their
5 ability in terms of achieving economies of scale, certainly
6 segregation of duties and responsibilities leads to
7 some of the circumstances that were alluded to where they
8 are really forced to go out and hire additional personnel.

9 And I think also it was interesting that
10 the GAO also highlighted these unique circumstances, the
11 smaller size of companies as also providing opportunities for
12 more efficiently achieving effective internal controls
13 because of management's day-to-day operational centralized
14 management, oversight of the business, greater exposure and
15 transparency within the senior levels of the company as well
16 as their hands-on approach.

17 And so inasmuch as we get to these kinds of issues
18 where you do have these kinds of efficiencies that are
19 potentially achievable and I think that our guidance is
20 intended to try to foster, we would want to make sure in the
21 appropriate circumstances, given objectivity and competence
22 and the kinds of approaches that we take in determining when
23 those factors are met, but you wouldn't want to lose
24 those kinds of efficiencies inasmuch as the small
25 company is able to benefit from them.

1 So I do think it is important that even here on the
2 work of others that if they are maximized -- if there are
3 efficiencies that are unique to small business, to small
4 public companies -- that we would want those efficiencies not
5 to be lost and be leveraged in fact with the audit for ICFR.

6 MS. PALMROSE: We agree. And actually, it's very
7 important because, remember, a lot of the small companies
8 aren't going to have internal audit departments. So
9 it is very important that we get this right for that
10 group of companies, too.

11 COMMISSIONER CASEY: Thank you very much.

12 CHAIRMAN COX: Thank you very much.

13 Is there any further discussion on this fourth
14 aspect?

15 (No response.)

16 CHAIRMAN COX: If not, I will summarize briefly the
17 recommendation of the staff.

18 Specifically, the SEC staff proposes to work with
19 the PCAOB staff, first, to provide principles-based
20 definitions of competence and objectivity that can inform the
21 auditor's judgment of individuals on this basis.

22 And, second, to ensure that the auditor can use the
23 work obtained from management's monitoring activities.

24 Do the Commissioners support the staff's approach?

25 COMMISSIONER ATKINS: Aye.

1 COMMISSIONER CAMPOS: Yes.

2 COMMISSIONER NAZARETH: Yes.

3 COMMISSIONER CASEY: Yes.

4 CHAIRMAN COX: Yes.

5 And that recommendation is agreed to.

6 That concludes the business on today's agenda. I
7 want to take this opportunity once again to thank Chairman
8 Mark Olson and the Public Company Accounting Oversight Board
9 for their contributions to today's meeting and, of
10 course, for their extensive work on these very subjects as
11 well as Jeff Steinhoff and the Government Accountability
12 Office for their extensive assistance in this effort. And
13 special thanks to the professional staff here today, Carol,
14 John, Conrad, Zoe-Vonna, Mike, Nancy, Brian and Josh and all of
15 the staff in your divisions and across the agency.

16 This is an exceptionally important work for the
17 Securities and Exchange Commission and for the PCAOB. I am
18 quite confident based on what you've told us today that our
19 Number 1 priority is ensuring audit quality and that we are
20 honed in on the importance of redirecting resources away from
21 what is wasteful and duplicative and toward what really
22 matters in ensuring the integrity of financial statements.

23 So thank you very much for your effort and thanks
24 very much to our Commissioners for the extraordinary amount
25 of high-level involvement that we have had in this effort. I

