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MEETING THE COMPETITIVE CHALLENGES OF THE GLOBAL MARKETPLACE

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C O N T E N T S

P R O C E E D I N G S

CHAIRMAN COX: Good morning. This is a meeting of the Securities & Exchange Commission under the Government in the Sunshine Act on July 25, 2007.

We have a great deal of work today. Today's meeting is going to cover three vitally important topics for the future of our capital markets.

We'll begin with rationalizing the implementation of Section 404 of the Sarbanes-Oxley Act. We'll move on to consideration of the role that International Financial Reporting Standards will play in America's future.

And finally, we'll consider two proposals to address the question of how the federal proxy rules can be better aligned with the state law rights of shareholders. These topics are very much related to one another.

As the world's capital markets converge and competition among both markets and financial products becomes broadly international, investors will demand more and more different things from securities regulation, that is, after all, intended to serve their interests.

They'll want to know that the costs of regulation are aligned with the benefits it produces, which is why we're considering a completely rewritten audit standard to implement SOX 404.

They'll demand better comparability among financial statements from issuers in America and around the world, which is why we're considering a Concept Release on the relationship between International Financial Reporting Standards and U.S. Generally Accepted Accounting Principles.

And shareholders of U.S. companies will insist that their property rights as owners and investors, which include above all else the right to choose the board of directors, be respected by the federal proxy rules.

As was pointed out recently by the Committee on Capital Markets Regulation, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors, giving foreign firms a competitive advantage.

For that reason, the Committee on Capital Markets Regulation urged the SEC to address and resolve appropriate access by shareholders to the director nomination process. We'll consider two very different approaches to that issue today.

So let's turn to the first item on the agenda, which is rationalizing the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.

The first item consists of two parts; first, approval of the PCAOB's Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting that is Integrated with An Audit of Financial Statements," a related independence rule and conforming amendments. And second, the adoption of a definition of the term "significant deficiency."

Next Monday, July 30th, will mark the five-year anniversary of the Sarbanes-Oxley Act. Section 404 has posed the single biggest challenge to companies under the entire act, without question has imposed the greatest costs, but it has also contributed significantly to more reliable financial information and more reliable financial reporting as companies improve their internal controls to meet Section 404's requirements.

For the past two years, the Commission, the PCAOB and our respective staffs have been hard at work to improve the implementation of Section 404 while maintaining Section 404's benefits and protections to investors.

Over this two-year period we've held two roundtables in 2005 and 2006 to listen to issuers' first- and second-year experiences with the PCAOB Auditing Standard No. 2.

We also issued a Concept Release Concerning Management's Report on Internal Control Over Financial Reporting. We proposed and adopted additional extensions of time for non-accelerated filers, certain foreign private issuers and newly public companies.

We provided the Staff Guidance. We convened the

Advisory Committee on Smaller Public Companies to study, among other things, the impact of Section 404 on smaller companies, and we proposed and adopted guidance for management to follow in conducting their evaluations of internal control over financial reporting.

With respect to the PCAOB and the internal control auditing standard, last fall and winter we worked closely with the PCAOB and its staff as they developed their proposed new internal control auditing standard, and we convened an open meeting of the Commission on April 4th to discuss with our staff their approach to the PCAOB's proposed new standard and the alignment of that standard with our own management guidance.

Along the way we carefully considered all of the public comments that we and the PCAOB received on Section 404 implementation. Many companies and their auditors are now entering their fourth year of reporting on internal control over financial reporting.

Throughout this period, management, auditors, investors and other interested parties have provided ongoing, extensive and enormously helpful feedback to both the Commission and the PCAOB about what has worked well and what could be improved.

On May 24th, the PCAOB voted to replace the auditing standard under SOX 404 that had led to excessive costs and serious implementation problems. They voted to replace it with a top-down, risk-based approach focused on internal controls that are material to a company's financial statements and scalable for companies of varying size and complexity.

This new standard, Auditing Standard No. 5, can take effect only if it is approved as final by the SEC. On June 12th, the Commission published the new standard for public comment, and the comments have been overwhelmingly favorable.

This morning, we consider whether to grant final approval to Auditing Standard No. 5. As we approach the five-year anniversary of Sarbanes-Oxley, we can be proud that confidence in our markets is restored, that compliance costs are coming down and that today the final approval of the PCAOB's Auditing Standard No. 5 will make a giant step forward in facilitating a more effective and efficient approach to the implementation of Section 404 by refocusing resources on what truly matters to the integrity of financial statements.

This is an exceptionally positive step for investors and for America's capital markets.

Although the new auditing standard and the Commission's guidance to management should enable cost-effective compliance with Section 404 for companies of all sizes, smaller public companies -- as defined by the report of the Advisory Committee on Smaller Public Companies, which is specifically referred to in AS 5 -- should particularly benefit from the scalability built into the PCAOB's new auditing standard and the SEC's interpretive guidance.

In addition, because we deferred Section 404's external audit requirement for the category of smaller companies that are non-accelerated filers until the filing of their 2008 annual reports, management of these smaller companies will have additional time to develop an evaluation approach specific to their facts and circumstances and to coordinate their approach with a cost-effective external audit.

We're confident that Auditing Standard No. 5 will improve effectiveness and efficiency and will reduce inventory compliance costs, and we're committed to ensuring that its implementation is consistent with our expectations.

To that end, we'll analyze real-world information to determine that the costs and benefits of implementing Section 404 are in line with our expectations.

In addition, through our oversight of the PCAOB's inspection program we'll monitor whether audit firms are implementing Audit Standard No. 5 in a manner designed to achieve the intended results of audit efficiency and cost reduction and whether the PCAOB is inspecting audit firms in a manner consistent with our expectations.

With a significantly improved audit standard that enables auditors to deliver the most cost-effective audit services, the SEC and the PCAOB expect a change in the behavior of the individuals who are responsible for conducting internal control audits.

I want to once again thank our staffs, in particular the Office of the Chief Accountant, the Division of Corporation Finance and the General Counsel's Office for all of their work. Your tireless efforts over the past year will benefit investors in our capital markets for many years to come.

Specifically from the Office of the Chief Accountant, I'd like to recognize Zoe-Vonna Palmrose, Brian Croteau, Josh Jones, Amy Hargrett, Esmerelda Rodriguez, Jeff Ellis and Kevin Stout.

From the Division of Corporation Finance I'd like to recognize Betsy Murphy and Sean Harrison. And, from the Office of General Counsel, David Frederickson. I'd also like to recognize the work of the PCAOB board and their staff for their efforts.

Finally, I'd like to take this opportunity to express once again the Commission's appreciation to our own Advisory Committee on Smaller Public Companies and the hundreds of investors, companies, auditors, professional organizations and others who responded to the Commission's and the PCAOB's various requests for comments regarding audits of internal control over financial reporting.

The Commission's efforts in improving Section 404 implementation were considerably aided by their helpful insights and suggestions.

So I'll now recognize John White, Conrad Hewitt and Zoe-Vonna Palmrose for a presentation of the staff's recommendation.

MR. WHITE: Thank you, and good morning. Chairman Cox and members of the Commission, as Chairman Cox has explained, we are here today to recommend that you approve the PCAOB's Auditing Standard No. 5, a related PCAOB independence rule, and conforming amendments to the PCAOB standards. Additionally, we're recommending that the Commission adopt a definition of the term "significant deficiency."

The PCAOB's Auditing Standard No. 5, if approved by the Commission today, will replace the current Auditing Standard No. 2. The Independence Rule 3525 will require auditors to obtain audit committee pre-approval of non-audit services related to internal control over financial reporting. As you may recall, Auditing Standard No. 2 contains a pre-approval requirement, but the PCAOB has determined that it was more appropriate to include this requirement in its ethics and independence rules rather than to continue to include it within its internal control auditing standard.

In addition, we are recommending that you approve for the first time a definition of the term "significant deficiency." We believe it is appropriate to include the definition of "significant deficiency" within the Commission's rules given the communications requirements in the rules implementing Section 404 of Sarbanes-Oxley as well as the certification requirements of Section 302 of Sarbanes-Oxley.

Including a definition of "significant deficiency" in Commission rules in combination with the definition of "material weakness," which was adopted by the Commission this past May, will enable management, appropriately and conveniently, to refer to Commission rules and guidance for the meanings of these terms rather than referring to auditing standards, which it does today.

Conrad and Zoe-Vonna will describe the proposed rule amendment to adopt the definition of "significant deficiency" and the comment letters received by the Commission on Auditing Standard No. 5 in more detail in a moment.

Before we move to that, I wanted to take a moment to reflect on the journey that we have taken to arrive at today's recommendations to the Commission, a journey that started soon after I arrived on the staff just a little over a year ago.

Addressing the implementation of SOX 404 has been a significant priority of the Commission over past several years. As you know, the Commission and the PCAOB have been working closely together during this period to improve the implementation of Section 404.

Going back to May 10, 2006, many of us were here in this very auditorium as the Commission and the PCAOB hosted a roundtable on second-year experiences with Section 404.

The roundtable was followed one week later with press releases in which the Commission and the PCAOB each announced a series of steps they planned to take to improve the implementation of Section 404.

In the Commission's press release, it outlined four actions that it was undertaking to improve the implementation of Section 404.

These actions were: One, issuing for the first time guidance for management in performing its assessment. Two, working with the PCAOB in revising Audit Standard No. 2. Third, providing extensions of the compliance deadline for non-accelerated filers; and 4, providing SEC oversight of the PCAOB inspection process which was designed last year to focus on the efficiency of Section 404 implementation.

So I'm happy to say that with its actions today the Commission will have affirmatively acted on three of these four steps by providing extensions to non-accelerated filers at the end of last year, through its approval of interpretive guidance for management this past May, and now today with its consideration of Auditing Standard No. 5 to replace Auditing Standard No. 2.

And that's not to say we haven't been working very diligently on the fourth item, our oversight of the PCAOB inspection process, but I'm going to leave that item to Conrad Hewitt to expand on in a moment.

So since the May 2006 announcements, the PCAOB, in coordination with the SEC staff has been working to provide a new auditing standard, one that makes clear that the auditor's primary focus during an integrated audit is on areas that pose the highest risk of material misstatement to the financial statements and that does not require procedures unnecessary to an effective audit of internal controls.

The PCAOB released its proposed new auditing standard in December of last year. Over 175 Comment Letters were received. In addition, as part of the Commission's process of issuing its interpretive guidance for management, we received over 200 Comment Letters many of which focused on the interplay between our interpretive guidance and the

PCAOB's auditing standard.

As a result of the comments received on both proposals, the Commission held an open meeting on April 4, which you alluded to, to discuss its views on the comments received with respect to the auditing standard.

The Commission directed the staff to focus on four areas when working with the PCAOB staff. The PCAOB and its staff considered the comments received and the Commission's guidance carefully and, as a result, made significant changes from its proposal in December.

So the end result of their hard work is an auditing standard that is shorter, less prescriptive, focused on the areas of highest risk and clearly scalable to fit any company's size and complexity.

Zoe-Vonna will speak in more detail about those changes, but I am very happy to report to you today that the staff of the Commission believes that you have a very much improved auditing standard for your consideration due to the PCAOB's and the Commission's coordinated efforts, and we in the staff are very pleased and very proud to make our recommendation to you here today.

Before I turn it over to Conrad I'd like to acknowledge the cooperative efforts within the SEC staff as well as with the staff of the PCAOB.

Investors in our capital markets deserve and they are relying on our hard work and our teamwork to improve the implementation of Section 404, and I believe the public has been well served by an abundance of each.

Chairman Cox, you've already thanked the many staff members who have worked on these releases as well as the PCAOB staff and the PCAOB who have worked with us. I just want to echo those thanks, and I say that with great sincerity.

I'm very, very appreciative to everybody who has worked on this project, now for all the time that I've been on the Commission staff. With that I'll turn it over to you, Conrad.

MR. HEWITT: Thank you, John, Chairman Cox and members of the Commission. The increased focus on companies' internal controls over financial reporting under Section 404 of the Sarbanes-Oxley Act and the Commission rules has led to an improved investors' confidence in our financial markets.

This improved confidence is a result of improved public disclosures related to ICFR. Also, the increased focus on internal controls has helped many companies to establish and maintain more effective internal controls.

However, as you know, these benefits have come with costs that were significantly greater than expected. Of particular concern has been indications of audit and compliance costs for smaller companies.

Concerns for Section 404, of course, are not new. Efforts by the Commission and the PCAOB have been underway for some time to meet the challenge of providing new guidance and revising the prior requirements to better balance the implementation costs with the benefits.

The proposed auditing standard that you are considering today to replace AS 2 is intended to address the specific concerns of smaller public companies by enabling and encouraging auditors to effectively tailor and scale their audits according to the relevant facts and circumstances of each company.

If adopted, the new standard will become effective for audits fiscal years ended on or after November 15, 2007. That's this year. However, it is important to note that early adoption of the new standard would be permitted.

In fact, the staff would encourage early adoption by auditors so that issuers and then investors can begin to benefit from the improvements that have been made relative to the effectiveness and efficiency in the conduct of internal control audits.

Although Zoe-Vonna Palmrose will discuss the comment letters in more detail I want to highlight one additional matter.

Some commenters expressed concern that there was not sufficient incentive for auditors to modify their methods of performing the audit of internal controls. Therefore, they were concerned that the benefits afforded by AS 5 would not be fully implemented and realized.

These commenters noted that it was important for the PCAOB to adjust its inspection program to align it with the many changes in the new audit standard and to respect the auditor's use of professional judgment in conducting the audit. Now, this has been an area that both the Commission and the PCAOB recognize and continue to focus on.

For example, the inspection process was an area specifically identified in the Commission's and the PCAOB 2006 Announcement of Actions following the Commission's second roundtable on Section 404 implementation.

The PCAOB has incorporated procedures to evaluate the efficiency and effectiveness of ICFR audits in their inspection process.

Further, as directed by the Commission, the staff is examining whether the PCAOB inspection program has been designed to be effective encouraging changes in the conduct of integrated audits to again to improve both efficiency and effectiveness of attestations on ICFR.

The staff recognizes that even with the adoption of a new standard the hard work is not over. Appropriate implementation will be just as important as having an improved auditing standard in place.

If approved, we will work closely with the PCAOB, management, auditors and others to monitor the implementation of this new standard. I believe that it is also important for audit committees to be involved with the implementation to enable the success of Auditing Standard No. 5.

The successful implementation of Auditing Standard No. 5 will depend on several participants in the financial reporting process.

For example, the PCAOB has indicated that it will retrain its inspection team and adjust its inspection program. External auditing firms will need to retrain their staffs and change their audit programs for a more integrated audit.

The management of each company can challenge its own evaluations of internal controls based upon our interpretive guidance. And just as important, audit committees should play a more active and direct role with particular attention to their Management Guidance implementation and the scope of the external auditor's year-end audits on an integrated basis in accordance with Auditing Standard No. 5.

Now, if above are implemented properly, costs should become more in line with the benefits for investors and particularly for smaller, including micro cap, companies.

Lastly, the staff believes it is appropriate for the Commission to include a definition of a term "significant deficiency" in the Commission rules.

The staff recommends that you adopt the definition which the Commission published for additional public comment in June. As you know, the definition of "significant deficiency" is used in the context of evaluating the minimum required communications under both Section 302 and 404 of SOX.

That is, "A significant deficiency is a deficiency or a combination of deficiencies in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for the oversight of a registrant's financial reporting."

We received 22 comment letters on this proposed definition, and the majority of the commenters expressed their support for it. In addition, the commenters noted that a consistent definition of "significant deficiency" in our Commission rules and the PCAOB standards was important.

The staff believes that the definition appropriately emphasizes the communication requirements between management, the audit committee and the independent auditors on those matters that are important enough to merit attention.

And the definition will allow management to use its judgment to determine deficiencies that should be reported to the audit committee and the independent auditor.

At this point, I would like to reiterate the chairman's thanks to all the staff who worked tirelessly on our efforts to improve the implementation of Section 404. During this process, we worked closely with the PCAOB.

And I would like to add my thanks to the board and staff of the PCAOB. We'd also like to thank the Commissioners and their staffs for all the hours they have worked together with us on this topic, a very important topic, over the past several months providing their input and guidance.

At this time, I'd like to turn it over to my deputy, Zoe-Vonna Palmrose, who will discuss the Comment Letters of AS 5 in more detail. Zoe-Vonna.

MS. PALMROSE: Thank you, Conrad. Let me begin by looking back a few months and reviewing. First, as John mentioned, the PCAOB received 175 letters when it exposed a draft of Auditing Standard No. 5 for public comment in December.

Then, as has been noted, at this year's April 4th open Commission meeting, the Commission and staff discussed the comments received by the PCAOB along with those received by the Commission in connection with its proposed interpretive guidance for management.

At the 404 meeting, the Commission directed us to focus on four areas when working with the PCAOB staff. Those areas were, first, aligning the proposed auditing standard with the Commission's proposed interpretive guidance for management, particularly with regard to prescriptive requirements, definitions and terms.

Two, scaling the audit to account for the particular facts and circumstances of companies, particularly in smaller companies. Three, encouraging auditors to use professional judgment, particularly in using risk assessment. And four, following a principles based approach to determining when and to what extent the auditor can use the work of others.

We're very pleased to be able to report to you today that the PCAOB has addressed each of these areas in addition to the other matters raised by commenters in the version of AS 5 they adopted in May and that you're now considering.

While I won't detail all of the improvements, suffice it to say this standard is much less prescriptive, appropriately allows for auditor judgment, eliminates unnecessary procedures from the audit and directs the auditor to focus on what matters most.

These improvements are significant, and they are responsive to the comments received by the PCAOB, including those discussed at our April 4th open meeting.

Now let me turn to the comments in response to the Commission's June 7th request for comment on the standard you have before you.

The Commission received 27 comment letters. These comment letters came from issuers, registered public accounting firms, professional associations, investors and others. Overall, many commenters expressed support for the proposed standard and recommended that the Commission approve the standard and the related conforming amendments.

Some of these commenters requested that this approval be done on an expedited basis to enable auditors to implement the provisions of AS 5 prior to the required effective date.

A number of commenters noted that AS 5 includes appropriate investor safeguards, that it will facilitate a more effective and efficient approach to the ICFR audit and that the PCAOB appropriately responded to concerns raised by issuers, auditors, investors and others.

Specifically, some commenters noted that the standard's focus on principles rather than prescriptive requirements expands the opportunities for auditors to apply well-reasoned professional judgment.

Still, a few commenters expressed their continuing concern that in reducing the number of ICFR related audit opinions from two to one, the Commission and the PCAOB retain the wrong opinion.

These few commenters indicated their belief that auditors should opine on the assessment made by management in order to comply with Section 404(b) of the Sarbanes-Oxley Act, which some go on to equate to opining on management's evaluation process.

These commenters expressed their belief that auditors opining directly on ICFR, as opposed to management's assessment, entails unnecessary and duplicative work. The staff has carefully considered this comment and continues to believe that consistent with Sections 103 and 404 of the Sarbanes-Oxley Act and the Commission's recent rule amendments AS 5 requires the appropriate opinion to be expressed by the auditor.

Further, the staff believes that an auditing process that's restricted to evaluating what management has done would not necessarily provide the auditor with a sufficient level of assurance to render an independent opinion as to whether management's assessment about the effectiveness of ICFR is correct.

Finally, the staff believes that the expression of a single opinion directly on the effectiveness of ICFR is not only important from an investor protection standpoint but provides clear communication to investors that the auditor is not responsible for issuing an opinion on management's process for evaluating ICFR.

In the staff's view, an opinion on the latter may not only have the unintended consequence of hindering management's ability to apply appropriate judgment in designing their evaluation approach but also may have the effect of increasing audit costs without commensurative benefits to issuers and investors.

As you know, the Commission sought comments on seven specific questions in a supplemental June release as part of its request for public comment. I'll touch on the responses we received to each of these seven questions, and then we'd be pleased to discuss in issues in greater detail and answer any questions that you might have.

On the first question with respect to whether materiality is appropriately defined throughout AS 5 to provide sufficient guidance for auditors, the majority of commenters who expressed a view on this question said yes.

Some commenters elaborated that while application of materiality concepts in the context of planning and performing an audit requires the use of judgment. AS 5 appropriately specifies the basis on which those judgments should be made.

The staff agrees that AS 5 adequately addresses materiality throughout the standard. Even so, a few commenters expressed a view that some auditors may need further and clearer guidance than is provided about materiality generally for integrated audits of both ICFR and the financial statements.

However, the staff does not believe that AS 5 is the appropriate forum to address broader questions about materiality as the concept of materiality is fundamental to the federal securities laws. Nonetheless, this is an area the staff continues to focus on in the broader context.

With respect to the second question as to whether the communication requirement regarding significant deficiencies will divert auditors attention away from material weaknesses, commenters who expressed a view on this matter overwhelmingly said no.

They said, for example, that AS 5 clearly directs the auditor to scope the audit to identify material weaknesses to be disclosed to investors, and the staff agrees.

With respect to the third question whether AS 5 is sufficiently clear that multiple control deficiencies should only be looked at in combination if they are related to one another, most of those commenting on this question said yes, that AS 5 is sufficiently clear in this regard although a couple of commenters disagreed, stating that the auditor is expressing an opinion on the effectiveness of internal control as a whole.

Again here the staff agrees that AS 5 is sufficiently clear and notes that it's aligned with the Commission's interpretive guidance for management in this regard.

With respect to the fourth question whether the definition of "material weakness" appropriately describes the deficiencies that should prevent the auditor from finding that ICFR is effective, the majority of those commenting on this topic responded affirmatively. And the staff agrees.

On the fifth question related to the auditor's use of the work of others, the majority of those who commented expressed their view that AS 5 is clear about the extent to which auditors can use the work of others to gain efficiencies in the audit with some noting that AS 5 provides substantial flexibility in the application of auditor judgment when determining whether and to what extent to use the work of others.

The staff agrees that AS 5 is sufficiently clear about the extent to which the auditor can use the work of others. However, two commenters recommended that if the work of others is found to be competent and reliable, then the standard should require the auditor to utilize it.

But while we anticipate auditors would use the work of others under appropriate circumstances, including when the approach results in greater efficiency, we do not believe that it's necessary or appropriate to preclude the auditor from utilizing his or her judgment in determining whether or not to use the work of others based on the particular facts and circumstances of the engagement.

As to the sixth question on whether AS 5 will reduce costs and result in cost-effective integrated audits, a number of commenters stated their view that AS 5 as approved by the PCAOB together with the Commission's guidance for management will result in a reduction of the total Section 404 compliance effort.

Some commenters agreed that a cost reduction would occur but also noted that the amount of reduced effort and cost associated with the ICFR audit will vary by company depending on factors such as the size, complexity, the degree of change from year to year, the quality of their internal control systems and documentation and the extent to which management appropriately applies the Commission's interpretive guidance for management.

None of the commenters suggested that costs would increase. Even so, so commenters noted that while AS 5 my curtail excess of testing of controls and reduce some of the unnecessary documentation currently required for Section 404 audits they still have concerns about the extent to which it will reduce costs for smaller companies.

A number of commenters urged the Commission and the PCAOB to closely monitor the extent to which the standard is implemented and achieves a reduction in costs and to take action if there's not an appropriate reduction.

In a minute, I'll say more about this issue, but first and relatedly let me cover the seventh question as to whether AS 5 inappropriately discourages or restricts auditors from scaling audits, particularly for smaller companies.

Most commenters who responded to this question said no. They noted that the standard appropriately discusses the concept of scalability based on size and complexity without including inappropriate restrictions on the auditor's ability to scale the audit.

The staff agrees that AS 5 appropriately recognizes scaling and tailoring of all audits to fit the relevant facts and circumstances so that ICFR audits will fit the size and complexity of the company being audited rather than the company's control system being made to fit the auditing standard.

The staff also agrees with the statement made by the board in its release to AS 5 that scaling will be most effective if it's a natural extension of the risk-based approach and applicable to all companies.

Before leaving question seven I'd also like to respond to the observation by some commenters that where feasible AS 5 should provide additional guidance on how to effectively plan an integrated audit for smaller companies along with some discussion of related best practices to enhance broader understanding of risk-based auditing.

First, let me mention that the COSO guidance issued a year ago and directed to smaller companies should be helpful to both those companies whose COSO as their framework for evaluating their controls and their auditors in effectively and efficiently implementing 404.

In addition, COSO currently is conducted a project to develop guidance intended to help organizations better understand the monitoring component of the framework and comply with Section 404 in a cost-effective manner.

Further and importantly, for responding to the concerns of some commenters, the PCAOB has underway a separate project to develop guidance and education for auditors of smaller companies.

We're monitoring this project. The staff recognizes its importance as part of getting a good implementation of AS 5 for non-accelerated filers on their first ICFR audits with their filings in 2009.

Moreover, in addition to this project, the staff is working in a number of other ways as we go forward to monitor the implementation of the Commission's new guidance for management and the PCAOB's new guidance for auditors.

As selected examples, the staff will continue its ongoing participation in public forums and events to discuss the significant improvements made by the Commission and the PCAOB.

As just one illustration, the staff participates in the PCAOB's forums on auditing in the small business environment. These forums are held throughout the country and designed to help share important information concerning the PCAOB with respect to registered public accounting firms and public companies operating in the small business community.

Presentation materials from past events are available on the PCAOB's web site. These forums along with our speaking engagements provide for excellent two-way communication so that questions that arise can be dealt with on a real-time basis.

Further, as Conrad noted, we expect a change in the behavior of the individuals who are responsible for following these new procedures. To that end, the PCAOB's inspection program will monitor whether audit firms are complementing the new auditing standard in a way that is designed to achieve the intended results.

And it's noteworthy that the PCAOB's Office of the Chief Auditor, which drafted the standard, helps train PCAOB inspectors on AS 5. Moreover, in our oversight capacity, the staff, at the Commission's direction, will monitor the effectiveness of the PCAOB's inspection process.

So these are among the activities that illustrate going forward both the SEC and PCAOB will be focused on whether audit firms are achieving an effective and efficient implementation of the new 404 guidance.

In closing, I'd like to reinforce the appreciation expressed by others to the Commission, including for your guidance to the staff throughout the year and especially at the April 4th open Commission meeting, to the PCAOB board and staff and to the Office and Division staff that have worked so hard on this project, including my staff, in particular, Brian Croteau, Josh Jones, Amy Hargrett, Esmerelda Rodriguez, Jeff Ellis and Kevin Stout.

Brian Croteau and Josh Jones, who have played key roles in our efforts to rationalize the implementation of 404 are at the table to help answer your questions. That concludes our opening remarks.

Chairman Cox, staffs of the OCA and Division of Corp Fin would be happy to discuss any questions that you and the Commissioners might have. Thank you.

CHAIRMAN COX: Thank you for that very complete presentation. This is a lot of work. We've covered a lot of ground, and I think everyone has a lot to be proud of.

At our April 4th open meeting, we discussed the need for AS 5 to make clear that the audit is scalable to account for the fact that companies come in different shapes and sizes and different complexities, and we were particularly focused on smaller companies.

So I want to begin by asking how does AS 5 do this specifically?

MS. PALMROSE: Well, let me start out by saying, first of all, its principles based. It offers the opportunity for the auditor to make judgments based on the facts and circumstances, and it's a risk-based approach, and so scaling is a natural extension of this approach.

Second of all, AS 5 includes specific discussion on scaling the audit based on size and complexity of the company, and the staff agrees with this discussion and that scaling is the most effective way to get -- that reflects this natural, as I said, extension of the risk-based approach.

Third, the Board made an important change from their December proposal. Not only did they have a special section that talked about scaling, but what they did is they imbedded scaling concepts that can apply in particular to small companies throughout the standard to help illustrate and provide a little bit more context and guidance in that setting.

And fourth, I should note that consistent with the discussion and plans there is the build-out of this guidance that is expected to come from the additional guidance that the board and staff are working on for smaller companies.

And that project is progressing nicely, will be available for public comment in the not to distant future and will be able to be applied by auditors of small firms well before the implementation for the filings in 2009.

CHAIRMAN COX: Thank you for that. We, of course, have published guidance for managements in meeting their obligations under Section 404(a). I seem to recall that the PCAOB is planning its own guidance for audits of smaller companies. How is that going?

MS. PALMROSE: That's going well. Actually, that was part of just, sort of, what I briefly ended on. As you know, the staff is an observer on that project. We've been working with them.

This project also has the advantage of having a task force that's made up of representatives from the public accounting firms, in particular the public accounting firms that are auditing smaller companies so not just the largest firms and their audits of smaller companies but the smaller firms, too.

So that task force has been working with the PCAOB. We've been working as observers, and that guidance will, as I said, be available for exposure in the not too distant future. But we are reviewing drafts of that as it goes along as are the task force. So it's going well.

MR. WHITE: I might also mention that we're working on a brochure for smaller companies that will be, basically, a plain English explanation of how to use management guidance and to, kind of, lead companies through this that we think will be helpful to them.

CHAIRMAN COX: And that's something, of course, that smaller companies have asked for, so that will be very responsive.

MR. WHITE: Yes. It is something that they have asked for, and it was discussed in your congressional testimony a few weeks ago.

CHAIRMAN COX: Excellent. John, you mentioned a number of ways in which the staff are going to monitor the implementation of AS 5 as well as Management Guidance.

I note that we received a number of recommendations that we perform a cost study of AS 5. Could you describe what plans you have to study -- what plans the Agency has to study the costs of AS 5 and Management Guidance and when you might be in a position to report to us on these costs?

MR. WHITE: We'd be glad to, but I think I'm going to let Zoe-Vonna do that because she has done most of the planning for this.

MS. PALMROSE: Well, I think that's overstated, but I certainly would be glad to provide some comments here. And the answer is yes, at the direction of the Commission.

Actually, our Office of Economic Analysis will be conducting an analysis to address whether the costs and benefits of implementing Section 404 are in line with our expectations.

The Office of Economic Analysis is working with the staffs of the other offices and divisions, and we have started the process of planning such a report. So we would be hopeful that those plans would be well in line within the not too distant future.

As part of this, I should reaffirm that -- and in light of this direction, we're also revisiting the other research that has been done in what I call the growing literature and research related to the implementation of SOX.

So it's not just our own efforts that we're considering, but we're considering the efforts of others, and that's informing not only how we think about the issues but also how we're developing our own study as we go forward.

So the answer is yes. We're working in a number of ways to move this project along, and we recognize its importance. And it's really part of our over-arching activities in a number of ways to work on the implementation of 404.

MR. HEWITT: I might just add on that point, if I may, KPMG, there are other organizations also that do studies on these costs and benefits. And KPMG just came out with their third annual benchmark study of 404, and it will be interesting to see next year's.

Because these costs won't be known until the end of this year or early next year as to what these actual costs are because of AS 5. There will be a lot of other information available that we'll be able to look at.

CHAIRMAN COX: Thank you for that. One of the concerns that we've heard repeatedly over the past years relates to management feeling that it's constrained by the auditor in the development and execution of their own evaluation of internal control over financial reporting under 404(a).

What is different about AS 5, as it's finally before us, that provides us comfort that that problem has been fixed?

MS. PALMROSE: Let me start off, and others can jump in here. First of all, there's a big change. AS 2 had what was known as the 40s paragraphs, which, essentially, required that the auditor evaluate management's process. Those are no longer in the standard. So there is no requirement in the standard for the auditor to explicitly evaluate management's process.

Second of all, there was no interpretive guidance for management. In other words, management actually looked to the auditing standard for guidance on doing their evaluation, and that's, of course, now changed with the guidance that we have provided for management.

Again, it's important to recognize we've worked to align that so it will work together with the auditing standard. So management can look to our rules for guidance, and the auditors can look to the auditing standard. Management does not have to look to the auditing standard.

Third of all, the auditor's report that I talked about briefly in my opening remarks we're down to one opinion, which makes sense, and that opinion is on the effectiveness of ICFR.

So there's no notion because of the auditor's second opinion that that would equate to evaluating management's process.

So all three of those are very helpful in responding in just big ways to this concern that management was constrained through their evaluation.

MR. WHITE: I kind of like to say it the short way, that no longer does management have to follow the audit standard, but instead the auditors have to adjust their procedures to follow what management does.

MS. PALMROSE: But let me just reinforce they are aligned so that they can work effectively and efficiently together.

CHAIRMAN COX: Well, that's good news. I just have one final question. I'm sorry. Do you have further comment, John, on that?

MR. WHITE: No.

CHAIRMAN COX: Okay. Just one final question about the range of comments that we received on AS 5. If you want to characterize the types of comments we received and in particular the comments that were received on significant deficiency and how we addressed those comments.

MS. PALMROSE: I can start out, and others can chime in. I think it's important to recognize, first of all, we very much appreciate, we understand how time-consuming it is to write us, and we've asked for comment in a number of ways a number of times.

But notice that the number of comments is much lower to AS 5 that was exposed for comment in June than it has been before. So it's less than a fourth of the people in terms of number.

More importantly -- which provides some inferences that the larger marketplace is very happy with where it ended up, and also that's reinforced by the comment letters themselves.

The comment letters are very supportive of this standard and where it ended up, and that's also in terms of the "significant deficiency" definition, too.

So there is contentment would maybe be the word I would choose with those standards and the proposed definition that will be in our rule as well as in AS 5. Overwhelming support I would characterize what we're hearing.

MR. WHITE: The other thing, and I pointed it out earlier, we think it is a very good thing if nothing more than just good housekeeping that we now have the definition of "significant deficiency" and "material weakness" in our rules.

We do, after all, ask CEOs and CFOs to certify with respect to those matters every quarter, and I think it's very nice to -- it's a good idea to have our own definitions there instead of having to look over at the auditing literature.

CHAIRMAN COX: Well, thank you. I haven't any further questions. I just want to add since I thank the Office of the General Counsel, Office of the Chief Accountant and the Division of Corporation Finance but I didn't thank the people who run them, I want to thank particularly John White, Conrad Hewitt and Brian Cartwright for all of your work on this over a very long period of time.

Since I haven't any further questions, it is up to Commissioner Atkins to carry the ball forward.

COMMISSIONER ATKINS: Okay. Thank you very much, Mr. Chairman. I, too, would like to commend the hard work of the Public Company Accounting Oversight Board and the staff here at the SEC and the Office of the Chief Accountant, Division of Corporation Finance and Office of Economic Analysis and the General Counsel's Office for all of your hard work.

The audit standard that we're considering today is intended to enable auditors to conduct top-down audits that are focused on matters that they believe give rise to the greatest risk of material misstatements.

Despite all of the public attention that's paid to other items on our agenda today, this matter is the most important that we consider today. I hope that today marks the start of a new phase of the life of Section 404 of the Sarbanes-Oxley Act.

The infant years of Section 404 have been, to say the least, unpleasant. I had better caveat that. At least audit firms have been trumpeting record earnings. A couple months ago I ran across a full page advertisement by one of the Big 4 that boasted about, "five straight years of double digit growth."

Now, this year, of course, just happens to be the fifth anniversary of the Sarbanes-Oxley Act. Implementation costs and efforts soared far above anyone's expectations. Accounting firms driven by pecuniary interest, a poorly written rule and risk mitigation had every incentive to engage in make-work efforts. Managers and auditors engaged in check the box compliance exercises at direct cost to shareholders.

Money and time spent on these exercises were diverted from other important areas. The magnitude of the troubles that arose under Audit Standard 2 made it clear to virtually everyone that mere modifications to the existing standard would not have been enough. A completely new approach was needed.

As the old Chinese proverb says, rotten wood cannot be carved. I'm happy today to be able to vote for the replacement of Audit Standard 2 with Audit Standard 5. The old standard is not being laid to rest a day too soon.

That said, we need to be cautious with respect to Audit Standard 5. Even under this less prescriptive leaner standard, success is not guaranteed. If this standard is implemented incorrectly, then we will not experience the clean break with the past that AS 5 is intended to bring to pass.

Many commenters warned us that we and the PCAOB cannot simply sit back and relax now that AS 5 is in place. It's incumbent upon auditors to take the new guidance to heart.

As part of this they will need to abandon the notion that AS 5 governs management and instead allow management to follow the top-down risk-based approach that we set forth in the management guidance that we adopted last month.

As the PCAOB itself has acknowledged, it must monitor the manner in which auditors implement the new standard. Likewise, the SEC, in fulfillment of its statutory responsibilities, must monitor how the PCAOB is overseeing the audit profession's implementation of AS 5.

We need to be prepared to make changes if AS 5 fails to deliver on its promises of reshaping internal control audits.

Until we know whether AS 5 works, a further extension for non-accelerated filers I think is necessary. Let us give these small public companies an additional year to observe how their larger counterparts implement AS 5.

I advocate not requiring them to file Section 404 audit reports until they file financial statements for their fiscal year ending on or after December 15, 2009. Congress, of course, is considering delaying all internal control reviews.

In the interim, I'm also looking forward to seeing the guidance that the PCAOB develops for audits of smaller companies, as we discussed earlier. I hope that this will go a long way towards addressing some of the concerns that small companies raised about the standard.

We're also considering, of course, the "significant deficiency" definition that's before us today, and I'm happy to support it as well. It's important both that we have a definition in our rules and that the definition matches the definition in Audit Standard 5.

Significant deficiencies have been a continuing source of concern for me, but I hope that the new definition will help to alleviate those concerns. As the new definition appropriately acknowledges, a significant deficiency is less severe than a material weakness.

Management and auditors are to concentrate their efforts on identifying material weaknesses. Accordingly, they should not scope or test for significant deficiencies. If attention is diverted to hunting for significant deficiencies, then internal control reviews will be derailed from their intended focus.

It is in no one's interest, least of all the shareholders, who pay for internal control work, if management and auditors get tripped up in trying to identify issues that are not material.

I approve also of the definition's pragmatic consideration of whether deficiencies are "important" enough to merit attention by those responsible for oversight of a registrant's financial reporting.

We should be clear this standard is consistent with the definition of "reportable condition," which is very well understood in the accounting literature.

As I mentioned, in connection with Audit Standard 5, implementation will be of the utmost importance. Even a well-constructed definition would be meaningless if the implementation is not carried out properly.

I just have a few questions for you. I know the hour is getting later. Paragraph 30 of AS 5 directs an auditor to ask himself "what could go wrong" within a given significant account or disclosure.

What boundaries are there to this question to ensure that an auditor does not invite mountains out of molehills through a series of extrapolations of what could go wrong? After all, it was just this type of thought process that led to so many problems under AS 2.

MS. PALMROSE: Let me answer that question. First of all, it's important to note where paragraph 30 appears. It's in the context of identifying significant accounts and relevant assertions.

In other words, what it is directing is for the auditor to think about the likely sources of potential misstatements that would cause the financial statement to be materially misstated. So materiality, what matters, what's important, bounds that discussion.

And it asks the auditor to think about what might be the likely sources of potential misstatement, and that's the "what could go wrong." It's not intended for them to consider every possible risk regardless of how insignificant.

Instead, it's really intended to help focus on what matters most and the risks that could result in a material misstatement, and, under a risk-based approach, obviously, this is the important question, so it is the essential question.

I also should add there's also a subtlety here that this question is actually one of alignment between management guidance and AS 5.

Management guidance does not require that -- our guidance for management does not require management identify significant accounts and relevant assertions. It's actually imbedded in the COSO framework, but our guidance doesn't say you must walk through that gate per se.

We say focus on the risk of material misstatement to the financial statements, and one of the subtle linkages here between what the auditor and management is doing is we included "what could go wrong" as the question that management would want to think about, too, in identifying those financial reporting risks, the risks of material misstatement.

So both the auditor and management, even if they don't use quite the same process or approach, are asking the same fundamental question, and both are taking a risk-based approach. And that's what is demonstrated by that question.

COMMISSIONER ATKINS: Okay. As we're talking about materiality, then, if you look just up from paragraph 30 up to the earlier one, paragraph 29, there it refers to the evaluation of qualitative and quantitative risk factors in identifying significant accounts and disclosures in their relevant assertions.

To get back to the point of materiality, then, what sort of qualitative factors are we talking about here?

MS. PALMROSE: That paragraph does provide some enumeration of what would be qualitative risk considerations Let me ask Brian to, sort of, jump in here.

MR. CROTEAU: As Zoe-Vonna said, actually, I think they're really listed there as examples of things you would want to think about.

Some of those are quantitative, and others are qualitative but making the point that clearly it's not just a quantitative analysis when considering significant accounts and that the auditors qualitative assessments can impact and, in fact, remove a significant account, if you will, or add a significant account.

So we think that's important so that it's not just a quantitative analysis that's done in considering scoping.

MR. HEWITT: A good example of that would where the estimates, the broad estimates in the accounting records and transactions and they end up in the financial statements whether it be warranty reserves, or those types of things. And those are all qualitative and not quantitative in nature, and that's where the risk is.

COMMISSIONER ATKINS: Right. But this is still bounded ultimately by materiality at the consolidated level as we talked about at the proposing?

MS. PALMROSE: Yes.

COMMISSIONER ATKINS: Okay. So of course, this, basically, comes to the crucial problem of materiality and how one is supposed to divine what that might be especially in a prospective sense.

And that has been particularly thorny, of course, in the internal control context and throughout financial reporting that we struggle with enforcement cases, and everything else.

So what steps are we taking to try to provide more clarity with respect to materiality in general?

MS. PALMROSE: Let me just start off by saying that you're absolutely right. The issues around materiality are really over-arching with respect to the financial statement audit that bleed into the ICFR audit.

So they're much broader issues here. So the staff is cognizant of that, and we do have in process work to examine the issues surrounding materiality both interim materiality and materiality in general.

So the staff is working that issue and would hope to have some recommendations going forward at some point.

COMMISSIONER ATKINS: Great. I would encourage that, because the last time the Commission -- actually, it was the staff, I guess, that addressed that was now eight years ago. I think it's high time that the Commission itself consider that.

So I would encourage the chairman and the staff to push this forward as fast as possible, because that is the thing that's eating away at a lot of these things that people have to deal with.

I guess sort of a related point is what material weaknesses are about and how they are defined. In paragraphs 69 and 70 of AS 5, they set forth indicators of material weakness.

Now, are these indicators which include, for example, restatements, are they definitive evidence of material weakness?

MS. PALMROSE: No. Again, notice one change between AS 2 and AS 5 is the term "strong" has been deleted. So they are indicators. And, in fact, the discussion around those both in the standard itself and in guidance, the released text as well as in management guidance are that these are judgmentally determined.

So they're based on the facts and circumstances, and these are just considerations. They are not determinative of a material weakness.

I might just add that the empirical evidence seems to support that. In other words, if we look at the material weaknesses, we find that the percentage of those that are reflected or are in conjunction with a restatement have dropped off significantly.

So it does appear that auditors and management and audit committees, issuers are sorting through this and understand that it is based on the facts and circumstances and a judgment determination.

MR. CROTEAU: And I might just add to Zoe-Vonna's comment to note that there's discussion of this in the PCAOB's release and our release that makes these points clear or at least interpretive guidance.

COMMISSIONER ATKINS: Okay. Good. Now, the definition of "material weakness" refers to interim financial statements. So I was wondering how do we square that with our emphasis on consolidated annual type outlook.

MS. PALMROSE: We actually did receive two comments. As you say, it does include in the definition of "material weakness" interim financials. We only had two comments on this issue.

So it doesn't appear that it's cause for much concern. Again, part of the angst around -- I should mention that one of commenters said, please, for heaven's sakes, don't hold anything up over this issue, too.

But let me just retrace my steps and say that our discussion around the issues with respect to materiality also relate to interim materiality, too. And the staff, again, is cognizant of that in the context of the broader project. So we understand that.

Anyway, from the standpoint of the ICFR audit, it's clear that scoping is based on annual materiality considerations. It's clear from the audit standard. It's clear from the release text. It's clear from our management guidance. There appears to be no confusion around that.

Now, "interim" is still in the definition, because we think that interim financial reporting is important to investors. And even though you don't scope around interim materiality, controls over interim financial reporting are, essentially, one aspect that has to be considered.

So those controls are something that needs to be considered. And also, and maybe most importantly, even though you don't scope to find, if you identify a material weakness, those -- excuse me.

If you identify a control deficiency, those controls deficiencies need to be evaluated as to whether they'll have a material impact on the interim financial statements, and that's all that this is asking to do here.

The staff believes that investors have a right to know whether the control deficiencies identified would have an impact on the interim financials, and it's a disclosure of that that's being asked for here.

COMMISSIONER ATKINS: I just wanted to bring that nuance out, because I think that's an important one from the scoping perspective. But of course, Qs are important also, as we know, for investors as far as the information that's disclosed.

The Biotechnology Industry Association objected to the removal of the definition of "small company" from AS 5 in our management guidance. Why was no objective definition included?

MS. PALMROSE: Well, actually, in both management guidance and in AS 5 there's still a footnote that recognizes the work of the Small Business Advisory Committee. That work is important. We very much appreciate it, informs the process, and there is that acknowledgment.

There's not a quantitative bright line that's specified that if you're on one side of it you're large and the other side that you're small.

That's actually an impediment to scaling. In other words, it wouldn't make sense for a company that had two companies, one just slightly over a bright line and one slightly under a bright line, but something different would happen to them.

That's not the way the standard is written. This is written so it's scaled based on facts and circumstances for companies based on their size and complexity, and those have to be determined within the context of each company.

Also, it would make no sense to have companies on the lower end of a bright line that had very different facts and circumstances and expect the auditor to treat them the same. So, essentially, the scaling is important here, and bright lines would be an impediment to that.

That's not to say that it isn't important to recognize that smaller -- the notion of a smaller company in conjunction with the complexity, and that's what is acknowledged with the footnote.

COMMISSIONER ATKINS: I agree generally with that. I just worry that auditors who might be free to exercise their judgment about whether scaling is appropriate might simply hide behind complexity and then refuse to scale audits of small companies.

MS. PALMROSE: I mean, it's unlikely that that would be the case, again, because that goes back to a risk-based approach. You'd have to identify what's higher risk.

So it's within that context. And again, that's what makes the scaling work for everyone.

COMMISSIONER ATKINS: I think, in general, I'm happy to support the adoption of AS 5. We might not be completely happy with it.

I'm at least happy to put AS 2 out of its misery or, more importantly, out of the shareholders' misery of paying for it. The secret will be in the implementation and how we monitor that. So thank you very much.

CHAIRMAN COX: Thank you. Commissioner Campos

COMMISSIONER CAMPOS: Thank you, Chairman Cox. Well, it has taken a long time to get here, but we've finally arrived. As promised, today marks the culmination of a tremendous amount of hard work and determination on the part of many people here at the SEC and at the PCAOB.

I won't go again and list the names, but I think all of you know who you are, and the chairman and your division directors have mentioned all of you.

Generally, first, I want to congratulate the PCAOB and their staff for responding to public comments and for crafting this excellent standard.

Second, I also want to thank the staff of our Office of Chief Accountant for all the efforts in the process. I know that the General Counsel, the Office of

Economic Analysis and other offices also participated.

I know that AS 5 is the product of intensive hard work and tremendous cooperation on the part of the staff of the SEC and the PCAOB. The adoption of AS 5 is evidence that we and the PCAOB have developed a framework to work on complex accounting issues and to resolve them in a professional manner.

I think it is an important milestone, and I think that we have overcome certain growing pains and that we have, hopefully, established a framework to deal with tough issues, good faith differences of opinion and still come out with a joint position on guidance and rule-making.

At this point, the SEC and the PCAOB, it seems to me, have done everything that we promised. After granting numerous extensions over the years to companies, particularly non-accelerated filers, we and the PCAOB have finally adopted standards and guidance for both auditors and management that should promote more effective and more efficient audits of internal control over financial reporting.

I'm confident that AS 5 and the management guidance will greatly help companies of all sizes but particularly smaller companies comply with Section 404 in a cost-effective manner that seeks to minimize the possibility of a material misstatement in the financial statements.

AS 5, as has been noted, is rational, right-sized and principles based, an approach that should enable auditors to properly scale the audit for smaller or less complex companies.

I'm confident that once auditors and companies begin to comply with and implement the new standard costs will be rational and appropriate for smaller public companies. From this point forward, issuers should have nothing to fear from Section 404 of the Sarbanes-Oxley Act.

Certainly, investors both domestic and foreign have always appreciated the protections offered by SOX 404. Now they will still have the protections offered by SOX 404, but they will also benefit by getting these protections in a more efficient and cost-effective manner.

As I repeatedly emphasized, the rigorous disclosure regime in the United States which protects the recent protections offered by Sarbanes-Oxley is a great protector of capital and, in my view, attracts capital from all over the globe.

Let me focus on a few discreet aspects of AS 5 that I think deserve mentioning. First, much has been made by making the standard more principles based and top-down focused.

This is entirely appropriate and necessary, but we can't lose sight of the fact that the passage of the Sarbanes-Oxley Act was due, in large part, to the massive financial frauds of a few years ago; that is, intentional fraud by senior management who managed to override internal controls.

In this respect, I think and hope that AS 5 has done an even better job of trying to focus auditors on the risk of fraud. Specifically, I know that addressing the risk of fraud has been moved into the "Planning the Audit" section of the standard.

The focus on fraud risk during the planning stage of the audit should put fraud risk in the minds of auditors from the very beginning of the process.

I also think it's appropriate that AS 5 provides examples of controls that might address fraud risks. This, too, should focus auditors on the biggest risk of a massive financial misstatement.

I'm also pleased with respect to the definitions of "material weakness" and "significant deficiency." I know that we specifically asked the question about material weaknesses when we voted to put AS 5 out for public comment.

I note that a majority of commenters believe that the definition appropriately describes the deficiencies that should prevent the auditor from concluding that internal controls over financial reporting are effective.

Further, it is entirely appropriate for the definition to reference interim financial statements. It makes perfect sense to me that if auditors uncover a deficiency that poses a reasonable possibility of a material misstatement in a company's Form 10-Q that deficiency should be disclosed to investors.

I also think AS 5 has done a much better job with respect to scaling the audit. In particular, I appreciate the fact that the standard emphasizes that scaling should be based on both size and complexity of the company.

As AS 5 notes, "Even a larger, less complex company might achieve its control objectives differently than a more complex company." Notably, however, the notion of scaling the audit should not result in a less rigorous audit, nor does it exempt smaller or less complex companies from any of the principles set forth in AS 5.

In general, what makes AS 5 an appropriate and consistent standard is that all of the parts seem to fit together in a way that, hopefully, will produce a more effective yet more efficient audit.

It allows companies to scale the audit to eliminate unnecessary procedures and to use more principles based approaches. In this way, auditors should focus on what matters most. Instead of checking the box auditors should focus on the big picture.

With that said, let me just ask a few questions. I've focused on fraud controls and the fact that auditors must consider the risk of fraud when planning the audit. Zoe-Vonna, do you think that AS 5 has done enough to focus on the risk of fraud?

MS. PALMROSE: Yes. Actually, this is one of the areas that is a change between the exposure draft and the final standard, and the board and staff have taken it very seriously and, as you said, have moved up the fraud discussion to the Planning section.

So the optics around it are important, too. That's part of emphasizing its importance. And as you said, there are now some examples of anti-fraud controls. And then the third thing is that the standard does discuss the expectation that fraud would be an area of high risk, and thus the auditor's efforts would respond to that higher risk.

And so all of those are important elements in bringing this focus on fraud to the forefront, and we're very supportive of that, yes.

COMMISSIONER CAMPOS: Given the significance of the improvements from AS 2, both auditors and management hopefully are very anxious for the new standard to be implemented. How soon can auditors begin using AS 5?

MS. PALMROSE: Well, actually, AS 5 is effective for years ending on or after November 15, 2007, but it's important to note that early adoption is encouraged by the PCAOB, and we very much support that.

We really encourage auditors to take advantage of this ability, and we've heard that a number of audit firms have already started updating and integrating AS 5 into their audit programs, their materials and their training. So it looks like that is happening.

Maybe I could use this as an opportunity to just cover something that's a little bit more technical here, too, and that's that the Commission's amendment to Regulation SX related to the required auditors attestation report -- that's the auditor's opinion on the effectiveness on internal control -- we adopted that in May. And it will become effective on August 27, 2007.

So companies can begin filing the new single ICFR opinions proscribed in accordance with AS 5 in timely filings received starting on August 27th. So this means that auditors can begin using AS 5 today and can actually report on it as long as the reports will be filed by their client on or after August 27th.

COMMISSIONER CAMPOS: Do you expect that to happen?

MS. PALMROSE: Yes.

COMMISSIONER CAMPOS: There has been much talk in various circles about the potential need of the small business community to get yet another extension.

Now, we all know that we have a year for the management guidance and the management assessment to be done before the second year and the second stage of full implementation for the smaller accelerated filers.

In your technical view, is that enough time?

MR. WHITE: Why don't I start on that.

COMMISSIONER CAMPOS: Sure.

MR. WHITE: I won't give the technical accounting view. I'm a lawyer, as you know.

COMMISSIONER CAMPOS: I won't hold that against you.

MR. WHITE: You probably should, actually, but never mind. Just to, kind of, break up the two pieces of it, the management assessment, of course, is due next spring, in March for the end of this year.

I think that at least listening to the advice of the accountants around me we are pretty confident that companies will be able to follow the new management guidance and comply with the requirement in that time frame.

Zoe-Vonna went through a fair amount of detail of how we had designed this and scaled it for smaller companies. We talked a lot about this back in May, actually.

And we were, obviously, thinking about at the time that this was in time and would work for smaller companies in terms of the management assessment that's due next March, the reports that are due next March.

In terms of the extension -- so the answer is we do not believe there are any extensions needed with respect to 404(a), because I think we were, basically, giving that advice back in May.

With respect to 404(b), in effect, that's more than a year and a half from now before those reports are due. We are, obviously, going to be monitoring how things are going with AS 5. As Zoe-Vonna just described, we anticipate that companies that are already subject to AS 5 will be complying with it I will just say this season.

So we will have kind of a season in which companies can -- we will see how it's working with larger companies. This is not something that you necessarily have to address at this stage. This can wait, basically. It is not a current topic, I would say.

MR. HEWITT: I would like to add some information on this point, because we're talking about micro cap companies, those with a floating market cap of under 75 million.

These companies operate in a completely different environment. Their internal control system environment is completely different than anything else. The auditors have to approach the audit in a different approach because of the size and characteristics of these micro cap companies.

So we believe hopefully that this year, when they address their management assessment of their internal control system that it will be very important if they do that, and they should do that.

They should also do it next year, because I think they'll gain some benefit by doing it, which they have never focused on before, especially as it pertains to any internal controls which they may have within these very micro cap companies.

Now, as AS 5 replaces AS 2, AS 2 was never scalable. It was a large portion testing standard that auditors converted into a percentage of assets and revenues. A very high percentage, almost 80 percent, had to be covered. Micro cap companies could not afford that type of an audit, and neither could a lot of small companies towards that lower end of the scale. So I think we really need later this year to see those smaller companies, say around $100 million of micro cap, to see how they are implementing AS 5.

PCAOB really has to pay attention to these micro cap auditors. These are not the Big 4 auditing firms. The Big 4 auditing firms do a very small percentage of these micro cap companies.

So you have a small CPA firm that's going to be auditing internal control systems. They do not have the training or the resources to get their people up to speed. But hopefully, they will be able to do the that by the end of this year.

And I would think that the external auditing firms of these micro cap companies will work with the management and their accounting and financial people to help guide them and to prepare them for an audit of their internal control system.

Personally, I want to wait and see to the end of this year to see how PCAOB does with the small CPA firms and how well they're trained, how well they understand AS 5 and scalability and then how well the small micro cap companies implement their management assessment of the internal control system.

MS. PALMROSE: Maybe I can just provide a little bit of a elaboration, too, to build on what Conrad has said. We've talked a bit about the project that the PCAOB is working on, on guidance for auditors of smaller companies, and that guidance will actually address the concerns that Conrad has raised in terms of auditing in a small company context.

That guidance will be in place in plenty of time to meet the audit requirements for the filings in 2009. The other point that we've talked about that's in place -- so all the components will be in place in order to do the audit in the small company context.

But there's something that we also haven't talked about that is a change from AS 2 to AS 5, and that's that AS

5 also focuses on an integrated audit. And this will be something that will be important in this context.

In other words, evidence from the financial statement audit informs the ICFR audit. Evidence from the ICFR audit informs the financial statement audit. And this is particularly important -- I mean, it's important in all companies, but it's also very important in this context in that these audits have tended to be substantive audits in the past.

And so there is now this mechanism that's explicit that's it's an integrated audit, and evidence from each informs the other. And so that should help the implementation of ICFR audits in this context, too.

COMMISSIONER CAMPOS: Well, in the smaller company context, can't we conclude that many of these companies have far fewer internal controls than what we ran into with the larger companies?

And if you envision that you have small internal staffs, whether it's one or two or even three, there aren't that many moving parts in terms of internal controls. It puzzles me why it should be so difficult to do everything that we, essentially, designed together with the PCAOB, with AS 5 and management guidance.

MS. PALMROSE: Yes. I think that's an important point. We talk about non-accelerated filers, but there's really a distribution here. It should not -- with management guidance and the auditing standard, it should not be that difficult.

COMMISSIONER CAMPOS: Okay. I'm going to stop it here. I'd like to thank everyone on our staffs, the PCAOB for all this time and all this effort and all this dedication to get AS 5 right and, of course, before then our management guidance. And I'm very, very pleased to support the finalization of AS 5.

CHAIRMAN COX: Thank you. Commissioner Nazareth.

COMMISSIONER NAZARETH: Thank you. As others have expressed, I would like to thank the PCAOB and their staff as well as our staff in the Office of the Chief Accountant for bringing this much improved auditing standard to us today.

I'd also like to thank the Division of Corporation Finance for their work along with OCA in crafting the proposed definition of "significant deficiency." And I'm happy to support approving the PCAOB's proposed AS 5 as well as the proposed definition.

With these actions today, we will address the most problematic implementation issues concerns the Sarbanes-Oxley Act. It is indeed a credit to the hard work of all concerned that the comment letters strongly support the new Auditing Standard No. 5. I believe that it is a tremendous improvement over AS 2, which is currently in place.

To the extent that the recent comment letters raised issues concerning the standard, most, if not all, such issues had already been raised and considered by the PCAOB in the course of its comment process.

I'm pleased to vote to replace AS 2 with AS 5, and I think that this new standard has the potential to result in lower cost than AS 2 while remaining consistent with investor protection.

I'm also very pleased that AS 5 is aligned with the interpretive guidance that the Commission issued recently for management. Through the revised standard and our guidance management and auditors will be directed to focus on areas that matter most, including those that pose a high risk of fraud.

Our staff has worked very closely with the PCAOB in our oversight role, and I think that the outcome here has been very productive.

At an open meeting on April 4, 2007, the Commission provided our staff with direction to work with the PCAOB in four particular areas -- alignment of AS 5 with the Commission's management guidance, improving the discussion of scalability within the standard, clarifying the auditor's ability to exercise judgment and following a principles based approach to determining when and to what extent auditors can use the work of others.

I'm pleased that AS 5 responds to these concerns that we raised at that meeting, and I'm optimistic that our interpretive guidance and the PCAOB's AS 5 will provide a useful coordinated framework for both management and auditors.

Included in AS 5 is a definition of "significant deficiency" that matches the definition the Commission recently published for public comment. The comments received strongly support that definition, and I'm pleased to support adopting that definition as well.

The definition focuses squarely on matters that are important enough to merit attention by those responsible for oversight of the company's financial reporting. An important benefit of the proposed definition is the flexibility that it will provide to management and auditors to use their judgment.

While I certainly agree with the criticism that the costs and burdens of implementing Section 404 of Sarbanes-Oxley have been far too high it is important to remember that there are real benefits to both companies and shareholders when issuers comply with Section 404, including management's renewed sense of ownership over controls, innovative ways to make controls more efficient, better financial reporting and disclosure and the detection of problems before they become more serious.

All of these benefits improve investor confidence and the integrity of our markets. By focusing on the areas of highest risk, we can best achieve meaningful investor protection without excessive costs.

The combination of the new AS 5 and the definition of "significant deficiency" that we are considering today and the guidance for management that we have already published will serve these important goals.

You've answered an awful lot of questions. I just have one area that I'd like to focus on, and it's one that others have expressed concern about, which is, obviously, the importance of implementation in achieving the goals that were intended by these important changes in AS 5.

Can you give us a little more specificity on how you intend to monitor implementation and whether there are any particular metrics that you're thinking of utilizing, either our staff or the PCAOB, to assess the goals have been achieved with AS 5?

MS. PALMROSE: We can talk about that in several ways. In terms of the specifics on whether the auditing standard is working, the inspection process clearly provides a very useful context to do that.

COMMISSIONER NAZARETH: But again, even as to the inspection process are there particular things that we intend to look at as we inspect the inspection process?

MS. PALMROSE: Yes. Let me just step back for a second here and say that our inspection of the inspection process is at, sort of, an odd place from the standpoint of AS 5 in that what is currently being done doesn't cover AS 5.

And so part of what we're doing here is also dialoguing with the PCAOB in terms of how they are implementing AS 5 through their inspection process going forward. So we're actually working in terms of our oversight with them on that.

There's multiple component to the inspection process. One is somewhat historical, but what we learn from that historical also informs how we think about the inspection for efficiency going forward.

And then there's an explicit component in terms of what they're doing going forward with AS 5, which has included the training that the Office of Chief Accountant is giving their inspection teams in terms of the standard itself. So that's one component.

The study that the Commission has directed under the leadership of the Office of Economic Analysis is another component of that, and here we're not only cognizant of what has been done -- we want to be cognizant of what has and is being done by others including, as Conrad said, surveys and evidence that's gathered by others.

And that's informing our, sort of, design here and methodology going forward. And again, that involves data that is both publicly available and there may be other components to that.

So that's what we're working on now. So it's a little premature to give actually a methodology and milestones on that. Then, again, working in terms of public speaking and outreach with the -- we actually work with the PCAOB and present as part of their forum. So those are scheduled.

And we have a number of speaking engagements and outreach activities scheduled to help educate as well as listen to the implementation of both management guidance and AS 5 and then working explicitly as an observer on auditing in a small business context project.

So that has relatively -- it's very important, but it has a relatively more recent time schedule. And hopefully, that will be out for exposure in the near future.

MR. HEWITT: I might just add to that point on how we can assure ourselves that the implementation will be completed as it should be when AS 2 was never completed.

For example, we'll be looking at the PCAOB's training manual and looking at their training program of their inspection teams to ensure that they stick to the concept of AS 5 in terms of scalability, in terms of principles based and not have items in their training program that may relate to, say, significant deficiencies, which do not belong in there.

So that will be our starting point. And as they perform their inspection and write their reports, we'll be looking in their reports and their working papers to see if there's something that does not jive with the intent of AS 5 in terms of implementing that standard.

So there will be a lot of work for us at the end of this year and next year in that regard to make sure that AS 5 is being implemented properly.

COMMISSIONER NAZARETH: Thank you. I think that's a good plan. Obviously, you've done a lot of thinking about it. It is, obviously, a very important part of this whole process in order to achieve the goals that were intended. Thank you.

CHAIRMAN COX: Thank you. Commissioner Casey.

COMMISSIONER CASEY: Thank you, Mr. Chairman. I also want to commend the staff for their extensive work on the significant deficiency rule change release and the AS 5 audit standard release. And I also want to extend my gratitude to the board and staff of the PCAOB for their work as well.

I believe that the SEC and PCAOB have made great strides in retooling the audit standard and aligning it with Management Guidance.

The Commission's consideration and anticipated adoption of AS 5 today is an important milestone in our efforts to achieve greater efficiency and cost savings under 404, but it is certainly not the final chapter, and we cannot simply close the book, claim success and move on.

We have made necessary changes. It is now incumbent upon us to ensure they are sufficient. Indeed, as everyone has worked thus far to undue the unnecessarily burdensome management and audit practices that have developed from 404 I think there is also a strong recognition that much work lies ahead to ensure these changes are implemented effectively and achieve their purported benefits.

Our recent release of management guidance and today's anticipated release of the new audit standard for internal controls are designed to help undo much of the burdensome consequences of 404 compliance; namely, they should drop costs down and are targeted to give the most relief to smaller issuers.

With the new guidance and standard, managements and auditors are empowered and encouraged to approach internal controls assessments and audits in a principled risk-based manner.

Our efforts have been focused on changing existing incentives and behavior so that mechanical and unnecessary box checking becomes a thing of the past and rational analysis by professionals and fiduciaries becomes the norm.

If this change happens, we should see the worst of SOX 404 disappear and the best of it -- investor confidence in financial statements -- apply to all companies. As we have no doubt learned from our work in this area over the last year among some of the key contributors to the 404 problems were the definition of "material weakness" and "significant deficiencies."

I am hopefully that our recent guidance, today's "significant deficiency" rule change and the new audit standard fix these problems by focusing the audit on identifying material weaknesses and ensuring that audits are not scoped to look for all deficiencies however insignificant or immaterial.

I have carefully reviewed comments about these definitions, and while no one can be sure it appears that those who most closely work with assessing the strength of internal controls believe that cost savings can be achieved but that in no event should these changes result in increased cost.

Another key problem was the undue cost burden expected to be borne by smaller companies when they are required to comply with 404. We have received many comments on AS 5, and while most are favorable in this regard believing that the new standard allows sufficient flexibility and risk-based judgment to scale audits to smaller companies several commenters remain concerned that scalability remains an unproven concept in the absence of clear definitions and guidance.

Indeed, this remains a central challenge that runs throughout our management guidance and is embraced in AS 5, attempting to infuse greater judgment and flexibility through a principles-based approach and avoiding detail checklists or rigid guidelines to become the de facto rule.

I believe there is great value in a principles-based approach and that we should resist returning to the prescriptiveness of the AS 2 approach despite the greater clarity that some commenters legitimately seek.

That being said we must gain confidence that scalability works before subjecting smaller companies to the costs of 404 and most particularly the audit requirement under 404B.

In the course of considering our efforts and the comments we have received on management guidance and on AS 5, I have become convinced that further delaying implementation of the 404 audit requirement at least for smaller companies is necessary and appropriate.

Delaying the audit requirement would be the most deliberate approach to ensuring that scalability and alignment are met for smaller companies before requiring them to bear the cost burdens of compliance.

Such a delay will ensure that the Commission and the PCAOB will be able to monitor how larger companies are faring under the new standard before subjecting smaller companies to the specter of 404 that may or may not work for them.

Indeed, it may not be possible to have a firm grasp on how the changes of both the guidance and AS 5 at least for larger issuers are affecting 404 implementation until summer of next year at the earliest.

Many of the comments we have received have called for "field testing," active monitoring and examination before proceeding with at least the audit requirement for smaller companies.

I believe these comments are consistent with how the Commission has suggested we intend to monitor implementation. The only question is what is a realistic time frame to do so.

Accordingly, the Commission and PCAOB need to remain engaged with this process to help users of this new standard and our management guidance achieve the benefits that we seek, and we must remain nimble and responsive so that if we find that costs are not coming down and that the unnecessary burdens of 404 are not lifting we can discover the causes and provide a remedy.

This means that we must also be willing to consider further revisions to this or related audit standards and further guidance for management. Along those same lines we must develop a plan for monitoring implementation of management guidance and AS 5 so that we know whether we are achieving our goals. We should consider how we will measure success, when and how we should take those measurements.

Likewise, we should be mindful of how we influence implementation of 404 through our inspections of the PCAOB and through our Examination, Compliance and Enforcement programs.

We do no greater harm than to ask the management and auditors to use greater professional judgment and then undermine that request by second-guessing that judgment if it is reasonable. So I look forward very much to monitoring our work in this area.

I would also note -- and actually, I have a question on this point that I'll direct, but I think it is worth noting that some commenters continue to believe that we have eliminated the wrong opinion and that in order to fix 404 we should require management to conduct an assessment of its internal controls and require the auditors to review that assessment rather than perform an audit of internal controls themselves.

These commenters argue it is the audit requirement itself that imposes undue cost not necessary to ensuring an adequate internal control regime. I believe that the Commission has sought to faithfully interpret and implement congressional intent on 404, and our approach reflects that.

Ultimately, only time will tell whether that opinion that we have eliminated will assist in driving costs down. I am hopeful that it will and committed to taking necessary steps to do so.

So with that I would like to ask the question on getting to some of the comments regarding eliminating the wrong opinion. Can the staff respond to the rationale behind it and why we're confident that the approach that we're taking is the right one?

MS. PALMROSE: Yes. Let me review some of the points I was trying to make in my opening remarks. This has been an issue that we've closely considered, and the PCAOB has, too. So there have been long and deep deliberations over this issue, and we're quite confident that we have selected the right opinion.

First of all, I think everybody agrees that it makes no sense to have two and that that was contributing to the problems and ambiguity. In fact, I will confess I taught it wrong. So I was part of the problem, and it's nice to be part of the solution.

But having said that, in all seriousness, we believe that the report on the effectiveness of ICFR satisfies the requirements of the Act, is what's necessary from an investor protection standpoint for the auditors to reach an opinion about the management's assessment and that this serves important investor protection and that it also has the side benefit of making very clear that the auditor is not opining on management's process. So the auditor is not driving management's evaluation process.

So it's a win/win from the standpoint of costs. It's a win/win from efficiency. It's a win/win from the standpoint of investor protection.

MR. HEWITT: I'd just like to add to that it's very difficult to audit management's process as such. Every company management will have a different process in terms of trying to establish their internal control system, and to audit that is not important.

What is important in the audit of internal controls is for the auditor to look and find the high-risk key internal control points within the system and test those controls to see that they're functioning properly.

It has nothing to do with the process or evaluation. So that's why the opinion is as we think it should be so the focus is where it's important and what is not important.

COMMISSIONER CASEY: As we monitor the

implementation, if we were to find that the cost savings and the efficiencies that we were expecting were not being achieved, would the staff make recommendations to the Commission on any changes that need to be made?

And have we had discussions or have we spoken to the PCAOB about having that kind of openness and ensuring that the standard and the management guidance are working effectively?

MS. PALMROSE: Well, at this stage, we're committed to going forward with the implementation and acquiring the evidence. So I don't think there has been any conclusion or prejudgment about what that evidence would be or how one would react to it.

I mean, one really has to see the evidence before one comes up with proposals to respond to it, but we're very optimistic, as I said, that with the guidance and with AS 5 that all the pieces are in place and we've rationalized this process.

COMMISSIONER CASEY: One further question. Some of the commenters raised concerns with management guidance or for smaller companies understanding what's required under management guidance. Clearly, it's voluntary, and we provide a safe harbor if they follow it.

There has been some discussion here about their ability to get input on how they should apply management guidance and COSO also providing a framework.

There has also been the notion of providing greater direction from the Commission or being able to be more responsive in providing answers to questions that they might have. There was some discussion about an ombudsman.

What challenges should we give consideration to in providing additional guidance?

MS. PALMROSE: Well, first, as you did say, in terms of more specificity about what an evaluation could consist of, COSO has actually provided that in the guidance that is available for small companies that came out I think it was last June or July. And so that is available, and that can be applied.

The staff does take calls in OCA, so we actually are responding to any requests for additional information and insights. So far the only request we've got is where is it, and we were able to respond to those. So far we haven't had questions develop, but we certainly are prepared to respond.

COMMISSIONER CASEY: Thank you very much.

MR. WHITE: As I mentioned, the Office of Small Business in Corp Fin is working on this brochure that will at least provide kind of a guide, I guess you would say. But of course the real place to look is in management guidance itself. I mean, it was written in a plain English workable way so that you can --

COMMISSIONER CASEY: Can you speak a little bit more about the guide again, about how it's going to work for smaller companies that you're drafting?

MR. WHITE: It is, we hope, a plain English user-friendly document that will help a smaller company when they are confronting, I guess you would say, starting down the road of management guidance of what's out there and the steps they need to go through.

As I mentioned earlier, this was actually, I think, a request of the chairman when he was testifying a few weeks ago on the Hill. We thought it was a great idea, and we've gone to work on it. I think we're going to be actually done with it pretty soon.

COMMISSIONER CASEY: Great. Thank you. I have no additional questions.

CHAIRMAN COX: Is there any other question or discussion? If not, we'll move to a vote on the two proposals.

First, does the Commission vote to approve the Public Company Accounting Oversight Board's Auditing Standard No. 5 and related Independence Rule 3525 and conforming amendments?

COMMISSIONER ATKINS: Aye.

COMMISSIONER CASEY: Yes.

COMMISSIONER CAMPOS: Yes.

COMMISSIONER NAZARETH: Yes.

CHAIRMAN COX: And the item is approved. Second, does the Commission vote to amend Exchange Act Rule 12b-2 and Rule 1-02 of Regulation SX to define the term "significant deficiency"?

COMMISSIONER ATKINS: Yes.

COMMISSIONER CAMPOS: Yes.

COMMISSIONER CASEY: Yes.

COMMISSIONER NAZARETH: Yes.

CHAIRMAN COX: And that matter stands approved. Thank you all once again for outstanding work, and I want to take this opportunity also to thank the chairman of the PCAOB, Mark Olson, the entire Board and their staff once again. This was very much a collaborative work over a long period of time, and I think we all have a lot to be proud of.

(A brief recess was taken.)

CHAIRMAN COX: The next item on today's agenda is a recommendation from the Office of the Chief Accountant and the Division of Corporation Finance that the Commission issue a Concept Release.

The purpose of the Concept Release would be to obtain information about the public's interest in allowing U.S. issuers, including investment companies, to prepare their financial statements in accordance with International Financial Reporting Standards as published in English by the

International Accounting Standards Board.

U.S. issuers, of course, currently prepare their financial statements under U.S. Generally Accepted Accounting Principles. The Commission has long advocated for globally accepted accounting standards that are high quality, comprehensive and rigorously applied.

As issuers and investors increasingly look beyond our borders for opportunities to invest and raise capital it's critical that the financial information they use to make their decisions be accurate and timely.

Among the obstacles that must be overcome in making investment decisions are the different ways in which financial information can be reported. Often the differences are due simply to the fact that the issuers are located in different countries.

That's why virtually everyone -- issuers, investors and stakeholders alike -- agrees that the world's capital markets would benefit from the widespread acceptance and use of high-quality global accounting standards.

Global accounting standards benefit investors by allowing better comparisons among investment options and increased access to foreign investment opportunities. They reduce costs for issuers who no longer have to incur the expense of preparing financial statements using different sets of accounting standards.

And lower costs facilitate cross-border capital formation as well as benefit shareholders who ultimately bear the burden of the entire cost of the financial reporting system.

Five years ago with the Commission's express support the Financial Accounting Standards Board and the International Accounting Standards Board formalized their commitment to the convergence of U.S. and international accounting standards.

More than two years ago we endorsed a roadmap that will commit us to eliminating the U.S. GAAP reconciliation requirement for foreign private issuers with the result that eligible firms listing on U.S. exchanges could choose whether to report under IFRS or U.S. GAAP.

Once the U.S. GAAP reconciliation requirement is eliminated, if an issuer chose IFRS, it wouldn't be required to reconcile the differences with U.S. GAAP just as today issuers reporting under U.S. GAAP are not required to reconcile the differences with IFRS.

In supporting convergence between IFRS and U.S. GAAP, the Commission has recognized that progress could result in IFRS and U.S. GAAP co-existing and even freely competing in U.S. capital markets.

This commitment to convergence has meant that issuers, markets and investors will some day have a choice, because they, not the government, will decide between IFRS and U.S. GAAP. It has also meant that the SEC was seriously contemplating a system in which both foreign and domestic issuers would someday have that choice.

In March, the Commission held a roundtable on IFRS to assess the impact of the co-existence of two sets of accounting standards on the U.S. markets, on the decisions that investors make and on the Commission's program of investor protection.

We heard from key participants in the capital-raising process -- issuers, accountants, investors, credit rating agencies, investment bankers and, of course, lawyers -- on whether the benefits of eliminating the U.S. GAAP reconciliation requirement for foreign private issuers are, in fact, achievable in practice, and their responses were resoundingly positive.

Today, nearly 100 countries require or allow the use of International Financial Reporting Standards. Since 2005, when the European Union mandated the use of IFRS for public companies in all of its member states, the Commission has received a significant volume of financial statement filings using IFRS from foreign private issuers.

Likewise, U.S. investors, analysts and others who rely on these issuers' financial statements are becoming increasingly familiar with IFRS.

In light of these developments and our roundtable, the Commission last month proposed to eliminate the requirement that foreign private issuers who submit financial statements prepared using IFRS also submit a reconciliation of those financial statements to U.S. GAAP.

This proposal, if adopted, would result in the co-existence of two different sets of accounting standards in the U.S. capital markets.

This morning we're considering publishing a staff Concept Release that solicits public comment on the future role of IFRS in U.S. markets and asks whether U.S. issuers should be permitted to use IFRS for purposes of complying with our rules and regulations.

In some respects, this is a mirror image of allowing foreign private issuers to file IFRS financial statements without reconciling their financial statements to U.S. GAAP, because it would give U.S. issuers the same choice that foreign private issuers would have.

This concept would also touch potentially every aspect of the U.S. capital markets from how U.S. accountants are educated and trained to how U.S. issuers prepare their financial statements, to how U.S. investors understand financial statements and to how accounting standards are developed and interpreted to apply to U.S. companies.

The purpose, then, of this concept release is to solicit views from a broad range of investors, issuers and other market participants on the benefits and the costs and the advantages and the disadvantages of allowing U.S. issuers to report using IFRS.

This public feedback will be enormously valuable to the Commission. In addition, many countries have already made the change from their home country GAAP to IFRS, and we would be particularly interested in hearing from issuers and regulators and other affected parties in these jurisdictions to understand and learn from their experience.

Before I recognize Conrad Hewitt and John White to lead the discussion of the staff's recommendation for soliciting that feedback through the proposed concept release I want to thank the staffs of the Office of the Chief Accountant and of the Division of Corporation Finance for your excellent work, in particular, Julie Erhardt, Jim Kroeker, Katrina Kimpel, Joe Ucuzoglu, Jeff Ellis, Stephen Brown, Mark Barton, Craig Olinger, Paul Dudek, Michael Coco and Sondra Stokes.

I also want to thank Ethiopis Tafara and Sarah Otte from the Office of International Affairs, Richard Sennett from the Division of Investment Management and David Fredrickson and Zachary May from the Office of the General Counsel.

So now I will turn it over to Conrad Hewitt and

John White.

MR. HEWITT: Thank you, Chairman Cox and members of the Commission. It is truly amazing for an accountant that has been in the business for as long as I have to present to you today a proposed concept release to allow U.S. issuers to prepare their financial statements in accordance with IFRS instead of U.S. GAAP.

When I began my career, it was a big deal during the course of any international work just to communicate with or visit others around the world. There was no thought of there being a practical way to work with the same set of accounting standards across borders.

I am pleased that not only are we considering it, but many others are as well throughout the world. I realize this is the case only by virtue of the work you cited of both the Commission and many other parties over the years.

All of these efforts have put me in a position where I, as Chief Accountant, think that it's appropriate at this time to recommend that the Commission ask investors, issuers, auditors and other market participants to help the Commission's exploration work by providing their views on the possibility of an IFRS option for use by U.S. issuers in preparing their financial statements for the purpose of complying with the rules and regulations of the Commission.

The draft Concept Release that you have before you is the document by which I recommend that the Commission seek this input over approximately the next 90 days.

Please let me emphasize that I see this Concept Release as just that, an information-seeking document, and it does not conclude that U.S. issuers should be permitted to report under IFRS much less provide a timeline.

Rather, among other things, the Concept Release describes and asks several questions about, A, the convergence work that has been underway for the past five years to align the content of IFRS and U.S. GAAP;

B, the appropriateness of exploring the possibility for U.S. issuers to have that option to report under IFRS while the convergence work continues and;

C, lastly, the effects on the obvious parties, investors and issuers, but also on other parties such as educators, auditors, specialists such as actuaries, regulators that are not security regulators and other market participants whose work would be impacted by implementing such an IFRS option.

It does not take very long in thinking about each of these aspects of this policy matter for many questions to come to mind since the U.S. capital markets have not previously experienced the wide use of two different sets of accounting standards by issuers.

The Concept Release would pose all those questions, and I am sure commenters will let us know if we forgot one or two.

Now, before I turn it over to John White, Director of the Division of Corporation Finance, I certainly want to express my thanks to all the members of our staff who have worked hard to think about these matters and prepare this Concept Release.

And I would like to especially mention to my left here Rick Sennett, Chief Accountant for the Division of Investment Management who is here with me at the table, for the contributions of his group with respect to working to make this Concept Release inclusive of the interests of the possible use of IFRS by investment companies.

I will now turn it over to John.

MR. WHITE: Thank you, Conrad. Good afternoon, Chairman Cox, Commissioners. As Conrad discussed, the purpose of this Concept Release is to raise a series of questions to solicit public input on the possibility of allowing U.S. issuers to present their financial statements prepared in accordance with IFRS as published by the IASB instead of in U.S. GAAP in their filings with the Commission.

Last month we were before you, and the Commission approved a proposal that we made for providing for specific rule changes which would allow foreign private issuers to present in their filings with the Commission financial statements prepared in accordance with IFRS without reconciling those financial statements to U.S. GAAP.

That proposal was a critical and dramatic step towards the regulatory framework that we're looking out towards of a single set of high-quality comprehensive global accounting standards.

And as I guess I've said many times, consistent and faithfully applied comprehensive global accounting standards will provide investors with an enhanced ability to compare companies and will serve to improve confidence in our markets.

So, all of this that I've described was the primary focus of a staff roundtable on IFRS that we held last March where I think most of us that are here today were at that roundtable.

What we're presenting to you today in the form of a Concept Release is, I think it's really fair to say, is an even more dramatic step than what you did last month, because last month what you did related to certain foreign private issuers.

Today we are talking about the possible choice to use IFRS by any U.S. issuer. We're talking about tenfold the number of companies that this would be available to.

If the Commission were to provide U.S. issuers with a choice to include financial statements prepared in accordance with either U.S. GAAP or IFRS, issuers would need to carefully consider that choice.

We recognize that not all U.S. issuers would choose to use IFRS. Some, including those that do not have a significant customer base or operations outside the United States, would likely continue to present their financial statements prepared in accordance with U.S. GAAP in their filings with us.

I think many of those companies are likely to be the smaller companies that would continue to stay with U.S. GAAP.

We recognize that providing U.S. issuers with this choice would allow them to use one of two different sets of accounting standards, and while this is a necessary step along the road to global accounting standards, it does mean that we would have two sets of accounting standards out there that would have equal standing, that would be co-existing in our capital markets.

Now, we recognize that this ability to use IFRS could benefit U.S. issuers in our ever increasing global capital marketplace, but we also recognize that investors and other market participants would need to understand and work with both IFRS and U.S. GAAP while comparing U.S. issuers, particularly since we expect many U.S. issuers would continue, as I said, to elect to stay with U.S. GAAP.

We need public input and believe this is the appropriate time to go out and seek that input, and that is why we're recommending this Concept Release to you.

We're very interested in all of the views on the questions that we pose and, as Conrad alluded to, there are a lot of questions in this release, particularly, or including, I guess I would say, the questions related to when any potential change in reporting requirements might occur and how that should be implemented. So I think this is just a very exciting time to see this release and to get it out there to start the dialogue.

Finally, in closing, I'd like to echo the Chairman's and Conrad's recognition of the staff's work in preparing the release. I guess I at this time need to go through the names myself, so I guess I will.

I want to individually recognize again in the Office of Chief Accountant Julie Erhardt, Katrina Kimpel, Gina Evan, Jim Kroeker and now I have the benefit of calling him by how all of us refer to him, Joe U. I stumble less with Joe U.

And in the Division of Corporation Finance, Craig Olinger, Sondra Stokes, Paul Dudek and Michael Coco and of course Rick Sennett in IM all for their invaluable contributions and I guess I would even say for their global vision in presenting this matter to you.

I guess I'd actually have to say that almost every one of the people that I've named has spent a lot of personal time with me teaching this topic to me and helping me understand it, and I really want to say thank you to everyone who has helped me with this process.

With that I'll turn it over to Katrina.

MS. KIMPEL: Thank you. The Office of the Chief Accountant and the Division of Corporation Finance recommend that you publish for public comment a Concept Release to elicit the public's interest in allowing U.S. issuers to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board for purposes of complying with the rules and regulations of the Commission.

The purpose of the Concept Release is to seek information about the potential effects that any such change may have on investors, issuers and market participants as well as the accounting profession generally.

The Concept Release describes the Commission's past consideration with respect to reducing disparity between the accounting and disclosure practices of the United States and other countries as a means to facilitate cross-border capital formation while providing adequate disclosure for the protection of investors and the promotion of fair, orderly and efficient markets.

Accounting standard-setters have been encouraged to do the same as demonstrated by the Financial Accounting Standards Board and the IASB being committed for the last several years to the convergence of U.S. GAAP and IFRS.

The Concept Release includes questions about whether the Commission should allow U.S. issuers, including investment companies, to prepare financial statements in accordance with IFRS as published by the IASB, including the anticipated effects on the U.S. public capital market of doing so and not doing so.

If the Commission were to allow U.S. issuers to file financial statements prepared using either IFRS as published by the IASB or U.S. GAAP there would be implementation matters. For example, the Concept Release includes questions about the need for education in IFRS for financial statement users.

We also are interested in the issues that would be encountered by U.S. issuers and their auditors in the application of IFRS in practice and existing Commission requirements.

Additionally, we are interested in what issuers believe the cost of converting from U.S. GAAP to IFRS would be. We are recommending that this Concept Release be open to public comment for a period of 90 days after its publication in the Federal Register.

COMMISSIONER CASEY: Yes.

COMMISSIONER NAZARETH: Yes.

CHAIRMAN COX: And the matter is approved. I want to thank everyone once again. And before you rise, because the Office of Economic Analysis was a significant contributor to this and because this is going to be Chester Spatt's last open meeting, I want to take this opportunity to thank on behalf of all of us our chief economist, Chester Spatt for your outstanding service.

The SEC was very fortunate to attract you in the first place from Carnegie Mellon. We were doubly fortunate when you re-upped for a second tour of duty.

You have distinguished this Agency with your own outstanding academic and professional reputation. You've added to the reputation of the SEC with your own luster. You've been an outstanding leader, a valued colleague and a giant in the ranks of investor protection.

So on behalf of all of us on the Commission and on behalf of all the professional staff here in the home office and the thousands of us across the country not to mention America's investors and everyone who depends upon free and efficient capital markets, thank you very much for your outstanding service for a job well done. And we wish you God speed on your return to academia.

MR. SPATT: It has been a privilege to serve at the

The Committee on Capital Markets observed that, "Overall, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors." And they added that, "This difference creates an important potential competitive problem for U.S. companies."

As one way of addressing that need, the committee recommended to the SEC that we take the opportunity of the Court's decision in the AIG case to ensure "appropriate access by shareholders to the director nomination process."

But we enter upon this discussion today with the full benefit of recent experience that ended badly. Four years ago under Chairman Donaldson, the Commission proposed a rule that would have established a mandated procedure under which companies would be required to include shareholder nominees in their proxy materials. That rule generated enormous controversy and was ultimately unsuccessful.

There are several lessons to infer from that experience. First, the federal proxy process must be respectful of the preeminent role of state law in determining shareholder rights.

Second, as we heard repeatedly at our three May roundtables on the proxy process, changes to the existing system, even changes that everyone agrees are improvements, should be measured and incremental to ensure that, first, we do no harm.

So your efforts are really tremendously appreciated by I'm sure all of us up here on the table. Thank you very much.

I just have one question, and that's for our General Counsel. Just exactly what are we voting on now? I just want to make sure that it's a draft as to the interpretation and proposal with respect to 14a-8(i)(8) that I guess I received last night about 11 p.m. give or take a few minutes.

And then as to the longer one, again it's a draft dated last night. I got it about midnight, and it's marked from changes from the 11th of July.

MR. WHITE: I'll let Brian finish the answer, but you received an action memo, as you described, last night around 11:50 that had attached to it both of the releases. And those are the two releases you'd be voting on.

MR. CARTWRIGHT: Just to complete the answer, I think, as in all matters that are brought before the Commission, the draft that is most recently before the Commission at the time of the vote is the draft on which the Commission is voting.

And I believe, if I understand, and I think my colleagues in the Division agree the drafts that you refer to are the drafts before the Commission.

COMMISSIONER ATKINS: Okay. I just wanted to make sure. Okay. With that, thanks. I look forward to hearing

to eliminate a particular opportunity that nuns, rabbis, Christian sects, environmentalists and others have used for placing non-binding proposals -- I'm sure I left someone out -- for consideration by management.

As stated in the roundtables, this particular procedure under our oversight and under 14(a) often presents ideas that eventually get traction, get legs and turn into real proposals that are adopted by the company.

So I'm interested in knowing what investors and commenters think about this particular question and the possible rule that may come out of this.

Is it good policy to allow a system to take away this particular practice and force those types of activists to use other tactics? I look forward to those comments.

As to the second release, I find myself in a position of not being able to support it. The second release, to my analysis, has many problems not the least of which is that it, essentially, puts investors in a position where they can no longer make any proposals if it were followed by the letter of the law, by the letter of this proposal.

However, I find that it seems to me to be somewhat deficient in that it doesn't really answer many of the questions that the Second Circuit put.

Without doing a legal analysis here, which I think others might be interested in doing, the Second Circuit did

The single-option proposal, the bylaw proposal offered today, announced only today only briefly visits this question and only addresses it through disclosure. And again, there were many other topics that were discussed, including the role in the proxy process of advisory services, broker voting, majority voting, empty voting and over-voting.

The release, in my view, does not seriously address many of these considerations, nor does it speak to or take stock in some other changes that have been going on in the market, including the rise of institutional investors and their ability to effect management and the new changes on e-proxy as far as bringing down costs for proxy solicitations.

The natural next step we should be taking in light of all the considerations advanced in our fact-finding roundtable is, in my view, a release that posits several different approaches and seeks comment upon those approaches but that also invites different ideas.

As I noted earlier, I understand that some effort was made in the last few hours to elicit such comments through questions, but the clear implication of today's single-option release is that the option is the preferred choice of the Commission.

And without a more informed discussion it cannot be my preference, and I cannot support the narrow bylaw proposal in its current form.

With that said, I'd like to just further inquire from the general counsel regarding the Second Circuit's decision. Can you please articulate exactly what the Second Circuit found in terms of our need to further explain our position?

MR. CARTWRIGHT: I don't think the Second Circuit found anything that was mandatory on the Commission.

COMMISSIONER CASEY: Okay.

MR. CARTWRIGHT: The Second Circuit did not accept the Commission's long-standing interpretation of existing 14a-8(i)(8), and therefore at the present time in the Second Circuit the Commission's interpretation does not stand. That was the conclusion.

COMMISSIONER CASEY: I'm sorry. Could you repeat that? I just couldn't hear you Brian.

MR. CARTWRIGHT: I'm sorry. And that was the outcome of that case. We participated as, in the view of the Second Circuit, as an amicus.

We're not a party, as we would not normally be in these circumstances, and they did not choose to adopt the view that the Agency propounded and which was consistent with the Agency's long-standing position. We lost.

COMMISSIONER CASEY: I appreciate that. So in your view, it was incumbent upon the Commission to do what in order to clarify its approach?

MR. CARTWRIGHT: Well, that's not strictly a legal question, I guess.

COMMISSIONER CASEY: Okay.

MR. CARTWRIGHT: If you were asking me what would be needed to minimize legal uncertainty, I would say a clear Commission rule-making. There's two proposals before the Commission today. The outcome, if either of those are adopted, will be a much greater clarity than exists at the moment where we have a single circuit at variance with the position of the Agency.

And as you know, within particularly what we've around here called the long release because it has more pages there's a fulsome set of questions. So there's lots of possibilities that remain open.

I think my colleagues in the Division of Corporation Finance expressed the view that they would be disappointed if the Commission were unable to come to some conclusion.

I think the Chairman has said very forcefully that he expects that the Commission will be able to reach a rule-making outcome. And if that happens, then we will have legal clarity, and the 2008 proxy season will be less potentially chaotic than it might otherwise be.

COMMISSIONER CASEY: Thank you.

CHAIRMAN COX: Commissioner Atkins.

And the recommendation is approved. There being no further business to come before the meeting, the meeting is adjourned. Thank you all for a long day.

(Whereupon, at 2:50 p.m., the meeting was concluded.)

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