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

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2 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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4 STANDING ADVISORY GROUP

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13 Thursday, February 22, 2007

14 8:30 a.m.

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18 The Army and Navy Club

19 901 17th Street, N.W.

20 Washington, DC

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2 MS. VIRAG: We presented the topics of
3 audit control over financial reporting to the SAG on
4 several previous occasions, most recently June of
5 2006.
6 As you know, this was shortly after the
7 board announced that it would be undertaking rule
8 making to change Auditing Standard Number 2 and we
9 had the opportunity to discuss with the SAG several
10 major areas of potential change.
11 The input that we received from the SAG in
12 June was an important and helpful part of the
13 development process of that proposal.
14 We are very pleased to have the
15 opportunity to obtain further input from the SAG on
16 these proposals to consider along with the rest of
17 the public comments that we receive. Just to remind
18 everyone, the comment period on these proposals ends
19 next Monday, February 26.
20 The topics we have selected for today's
21 discussion are among those that have been raised in
22 comments we received so far. We are presenting these

1 issues here today to promote additional discussion
2 and provide as much input as possible for the board's
3 deliberation.
4 The topics we have singled out for
5 discussion include whether the proposed standard
6 allows for the appropriate use of auditor judgment
7 while sufficiently safeguarding the quality of the
8 audit, whether the proposal adequately emphasizes the
9 importance of company level controls and the effect
10 they may have on the auditor's testing, whether the
11 direction in the standard on scaling the audit
12 sufficiently addresses differences in company's size
13 and complexity, whether differences between the
14 process management would follow to perform its
15 evaluation of internal control under the Securities
16 and Exchange Commission's recently proposed guidance,
17 and the process the auditor would follow to complete
18 his or her audit under the board's proposed standard
19 would result in any implementation issues. And if
20 so, how those issues might be addressed or managed.
21 Finally, whether the proposed audits
22 standard on considering and using the work of others

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1 would meet the objective of removing unnecessary
2 barriers to using the words of others and to promote
3 better integration of the audits.
4 Additionally, we plan to have time left at
5 the end of the discussion for SAG members to bring up
6 any other topics related to the proposals that they
7 believe need to be addressed.
8 In order to keep time for that, we plan to
9 move through the questions by devoting 30 to 40
10 minutes to each topic. With that, I'd like to open
11 the discussion with our first topic, auditor
12 judgment.
13 We have two questions on the topic and
14 you're welcome to discuss either or both at this
15 time.
16 Cynthia Cooper?
17 MS. COOPER: I think that the new standard
18 is definitely going to be less prescriptive and
19 allows for more auditor judgment, which is good.
20 Hopefully, we'll start to see more
21 reliance by the external auditors on others. It will
22 be interesting to see how that plays out. As far as

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1 the quality of audits, I think that really will come
2 back to the competence, to the objectivity, to the
3 independence of the individual audit team.
4 And I also think that the inspection
5 reports are going to play a key role in setting the
6 tone. While the inspection reports I think are an
7 excellent way to give feedback to the firms, I think
8 it is critically important that the inspection
9 process be in sync with the tone that we want the
10 standard to set, because if the auditors use judgment
11 and these inspectors come back and second-guess that
12 judgment, for example, obviously it is going to
13 impact the audit going forward. In some cases, maybe
14 that's necessary but we need to make sure they're
15 both in sync.
16 MS. VIRAG: Joe Carcello.
17 MR. CARCELLO: I applaud the SEC and PCAOB
18 for their work. In an environment characterized by
19 intense lobbying by well-funded and well-organized
20 groups that often were more concerned with their
21 narrow self-interest than with the public good.
22 Given this political cauldron, I think

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1 both groups have crafted reasonable standards.
2 Nonetheless, I have reasonable concerns with the
3 exposure drafts. AS-5 is less detailed, some would
4 say more principled, than was AS-2. And since
5 principles-based guidance is currently in favor, this
6 must be good.
7 But critically, for a principles-based
8 regime to work, there must be vigilant and effective
9 enforcement. Is this true? The PCAOB has adopted an
10 inspection model, not an enforcement model. That
11 basically leaves it to the SEC. The SEC enforcement
12 budget has been squeezed in recent years. What is
13 the back stop? The back stop is private securities
14 litigation.
15 But accounting firms are seeking liability
16 relief with some support, it seems, from the SEC.
17 And even the SEC has recently filed a friend of the
18 court brief with the U.S. Supreme Court that would
19 make it harder for investor lawsuits to succeed.
20 My overall conclusion is the PCAOB and
21 PCAOB's efforts would likely reduce costs without
22 hurting good actors, but at the cost of reducing

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1 effectiveness for bad actors. Is this socially
2 optimal? Is this in the best interest of investors?
3 These are the questions that I think the
4 board should be asking itself.
5 MS. VIRAG: Bob Kueppers?
6 MR. KUEPPERS: Thank you, Sharon.
7 Two things to the questions on the table
8 right now. I agree that the changes in the standard
9 do provide for the appropriate level of auditor
10 judgment. What we had before AS-2, as Cynthia said,
11 was a prescriptive standard, but guidance suggesting
12 that overlaying that is all kinds of opportunity for
13 judgment. I think this standard finally brings into
14 line that notion and the construction of the standard
15 itself. I think it will give us the appropriate
16 flexibility. I welcome and I think my partners will
17 take the spirit of that in implementing the standard
18 which I think will be good on the cost side.
19 The second question about safeguarding the
20 quality of the audit, I think the fundamental
21 safeguard built into the standard is the fact the
22 standard applies equally to all entities. In other

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1 words, it is a single standard for all, scaleable
2 based on size and complexity. I think size is an
3 interesting metric, but I think complexity is much
4 more the driver of how much work is appropriate in a
5 given set of facts and circumstances.
6 I think the standard has a single model as
7 opposed to a multiple model or other construction
8 that should serve if scaleability is -- I'm sure
9 we'll talk about scaleability. If that's
10 appropriately dealt with, audit quality will be
11 preserved and overall I think the exposure draft is
12 an excellent move in the right direction.
13 MS. VIRAG: Jeff Steinhoff.
14 MR. STEINHOFF: I'd like to reinforce a
15 couple of comments already made. I do support
16 strongly the move toward risk-based. I think it is a
17 big improvement over standard 2. This, though, on
18 its own -- I think Cynthia was getting to it -- does
19 not assure quality. It will be very important that
20 the PCAOB and SEC reinforce what the overarching goal
21 is and that is to protect the investor and to assure
22 there is a quality audit.

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1 I think it is very important -- the point
2 Cynthia was making -- that there be a direct tie
3 between the standard, how the inspections are done,
4 and the messages that are being conveyed. The point
5 that was made about good and bad actors, those that
6 want to do the job will see this as an opportunity to
7 do it in a efficient and effective way. And those
8 who perhaps never wanted to do it will see this as a
9 way out.
10 So you want to assure that people don't
11 see it as a way out. They see it as a more efficient
12 and effective way to do the job better.
13 MS. VIRAG: Kimberly Gavaletz.
14 MS. GAVALETZ: I want to applaud the
15 efforts of the PCAOB. I think they listened to a lot
16 of things people around this table have brought
17 forward in a thoughtful way. I do agree with the
18 less prescriptive nature of the standard as written.
19 I believe it sets the appropriate level. It says in
20 a way it had to be done relative to risk-based. That
21 in itself will have to be evidence that the
22 inspectors will be able to look at.

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1 I do share Cynthia's opening comment
2 relative to the concerns that tie with the
3 inspections to ensure that that risk base is
4 interpreted in an appropriate way. And really I
5 think you can do that by looking at how risk base is
6 applied and look at the process that the audit firms
7 are doing to try to get their judgments without
8 necessarily questioning the judgment underneath.
9 So I would -- you will have to say there
10 may be appropriate judgments announced in some of the
11 early inspections that had to be dealt with, but a
12 focus on the process will be important as you go
13 forward.
14 MS. VIRAG: Gaylen Hansen.
15 MR. HANSEN: I would also like to add my
16 thank you for all the hard work. I'm sure this was
17 very difficult to do, and we've had a lot of
18 discussions about that. I think there's some changes
19 that really will help us, in particular, some of the
20 definitional changes of significant deficiencies,
21 material weaknesses, clarifying the objective of what
22 we're actually trying to accomplish here. I think

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1 going to some of the language in standard number 5 on
2 probability measures was really helpful from my
3 viewpoint.
4 With that said, I think there's still room
5 for improvement. I think on the -- all of the
6 language about the small business scaling and
7 complexities is great. How to apply this judgment,
8 the latitude we get and our clients get is really the
9 real issue.
10 I recognize that really defining what that
11 judgment means in this kind of standard is extremely
12 difficult, probably can't be done unless you are
13 approaching it from a principles-based standpoint.
14 And I wonder whether or not anyone has given some
15 thought to something along the lines of a prudent man
16 approach to this, a reasonableness standard that you
17 see in some of the legal definitions.
18 By that, what I mean is I am very hesitant
19 to approach a client and say, well, you need to add
20 people to your staff just so that you can provide
21 separation of duties. To me that wouldn't
22 be prudent. I probably wouldn't do it.

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1 So I think we need some examples of what
2 clearly would be a material weakness, some instances
3 of what wouldn't be. And then the difficult part of
4 this is what falls down in between.
5 And I do have an example that I would like
6 to share this morning. We have a client in the Rocky
7 Mountains, a SPAC -- a special purpose acquisition
8 company -- subject to AS rules this year because it
9 has in excess of 150 million in cap. And that 150
10 million in cap is cash. Has two employees. A few
11 equity transactions. All of its expenses are
12 professional fees and salaries.
13 Where does this fall out as far as
14 segregation of duties and does it have a material
15 weakness when the CFO is basically doing everything?
16 And the only judgment the CFO has to make is whether
17 or not the small amount of goodwill on the books
18 needs to be impaired.
19 So that's an example of the things that we
20 are dealing with in our office. And I think that
21 maybe this prudent man definition would help some of
22 the small filers, some of the small firms deal with

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1 the forthcoming AS-5.
2 MS. VIRAG: Ted White.
3 MR. TED WHITE: Thank you. It seems to me
4 to be inevitable that some level of judgment is going
5 to be maintained here. And I generally support that
6 concept. But it also appears that the question on
7 the table is maybe missing the larger issue which is
8 the risk-based approach from which those judgments
9 are based upon.
10 First, let me say, I think the concept is
11 solid, and I very much like the philosophy of a
12 risk-based approach. It seems in a resource
13 constrained world, investors can benefit from a truly
14 rigorous risk-based approach that is functional and
15 accurate and gets auditors to focus the resources in
16 the right places.
17 I have a simple question about the
18 definition of risk-based and what it actually means
19 going forward, and is it different than what people
20 have, this sort of negative perception of whether
21 risk-based worked in the past.
22 First, I'd like to understand, what are

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1 the fundamental differences going forward in how we
2 define risk-based approach from a past -- from a
3 top-down risk-based approach? Is it different? Are
4 we doing the same things?
5 It seems that even your most recent
6 inspection report would indicate that at least in
7 these anecdotal cases, the assessment of risk was not
8 making the auditor focus their attention in the
9 correct places. They missed it. Didn't pay
10 attention. First, is it okay to get that concept on
11 the table under this point? Is that question fair?
12 MR. RAY: I'm sorry, Ted.
13 Specifically what question would you like
14 to throw on the table at this point?
15 MR. TED WHITE: First, I'd like a basic
16 explanation of the risk-based methodology that we
17 would use to be making the judgment calls here. It
18 seems to me -- first, tell me if I'm wrong in that
19 that would really be the underpinnings of whether the
20 appropriate level of judgment is applied in this
21 standard? So if the judgments are going to be based
22 upon a risk-based approach, is the risk-based

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1 approach appropriate to set those judgments?
2 Whether or not there's judgments or not,
3 seems to me to be -- that's a foregone conclusion.
4 Auditors have to make judgments. There's no --
5 unless you have no resource constraints where they
6 recreate everything -- and that's ridiculous, they
7 have to make judgments. I'm willing to just accept
8 that.
9 But it is the process that drives them to
10 make those judgments and where they're going to apply
11 the resources that seems to me to be more important.
12 MR. RAY: Well, I'll go ahead and add a
13 commentary here. My colleagues perhaps would like to
14 add some color to it as well and then throw it back
15 to the floor.
16 But basically my view on the risk-based
17 approach is that the concept of risk is an important
18 aspect of many of the points through the process of
19 conducting the audit of internal control. In order
20 to evaluate the risk, the auditor doesn't just
21 evaluate in a vacuum. The auditor must go out and
22 obtain knowledge and evidence related to the various

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1 risks that the auditor needs to assess, then perform
2 a judgment about those risks.
3 So there is a due diligence or a due care
4 standard I think that would be applied around the
5 auditor's procedures, around the -- what the auditor
6 does to obtain the information necessary to assess
7 the risk and then support the judgments that the
8 auditor needs to make.
9 MR. TED WHITE: Uh-huh. That's not
10 exactly the question. Does that work? Has that
11 worked? Isn't that the fundamental underpinnings of
12 this question, this position?
13 MR. RAY: The standard itself does try to
14 provide direction around what the auditor should be
15 doing to satisfy that -- those requirements, that
16 standard, and the objectives. With regard to your
17 question, I think I would turn to the various members
18 of the group here to comment.
19 MS. VIRAG: Craig Omtvedt, do you want to
20 comment?
21 MR. OMTVEDT: Just to set the stage a
22 little bit, I would say to you that I think the

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1 guidance that's come out from the SEC to give
2 management perspective on how to approach its
3 fulfillment of its control responsibilities, I think,
4 is a very positive thing.
5 I think the changes that you're proposing
6 here with AS-5 to go to a more risk-based approach is
7 fundamental and aligned with basic concepts of
8 assuring we get appropriate return on investment for
9 the activities that take place.
10 The return on investment here, obviously,
11 is greater investor confidence in the financials that
12 are being put out.
13 But to play off Ted's point a little bit,
14 I think there are modifications that we need to be
15 considering and perhaps institutionalize in terms of
16 how the auditors perform their risk assessment.
17 And I would suggest to you that it should
18 be more than simply operating within the company to
19 get a sense of what's the tone at the top, what's the
20 quality of the control process put in place.
21 I think there's external diagnostics that
22 candidly I don't think are being given enough

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1 attention. I think things that should be looked at
2 would be things like sell side analysts reports,
3 looking at peer companies, making sure the firm and
4 engagement partner really understand the dynamics of
5 the industry within which the company is operating.
6 I think there's things such as looking at
7 company's margins. Do they make sense in the context
8 of the overall industry?
9 You know, there's evidence in the past --
10 and I'm not going to get into particular frauds --
11 but with all the competition, we're saying there's no
12 way in hell those margins can be right.
13 You ask yourself: Why aren't the auditors
14 focused on those kinds of things?
15 So I think as we think about not just this
16 risk-based assessment makes sense, we need to come
17 back to what's the guidance and what's the standards,
18 what are the factors that need to be considered in
19 performing that assessment, and it needs to go beyond
20 just the company itself.
21 MS. VIRAG: John Morrissey?
22 MR. MORRISSEY: I guess I'll jump around

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1 and go back to the questions initially on the table.
2 I think it's important just to remind even myself
3 that I was not a big fan of opening up AS-2 to begin
4 with. I thought it was a good standard, rigorous
5 standard.
6 It was intended to be such. And I guess I
7 was a little concerned when I lost that debate that
8 AS-2 was going to be opened up. Having said that,
9 also, the concern is, is there enough opportunity for
10 professional judgment in the proposed standard? My
11 view is that AS-2 was fraught with opportunities to
12 exercise professional judgment. The words I think
13 were there. For whatever reasons, people weren't
14 reading the words and weren't following what the
15 words allowed people to do.
16 You look at the notion of risk-based audit
17 as being the new way to do auditing. That's nothing
18 new. It was available to preparers under AS-2. A
19 lot of companies weren't using a risk-based approach.
20 That's really not anything that's terribly
21 revolutionary.
22 Risk-based audit proposals, unfortunately,

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1 were in vogue back in the late '80s and weren't
2 executed very well. That's a concern people have to
3 this day that it is used as an excuse to cut back on
4 work and not focus in on the quality of what you are
5 trying to do. And risk-based approaches sometimes
6 are done by lower level staff people that aren't in a
7 position to have that in-depth knowledge of the
8 business and industry in order to properly assess
9 those risks.
10 If properly executed at the right levels,
11 it could be very, very effective.
12 To the last point, is the proposed
13 standard sufficiently rigorous to safeguard the
14 quality of an audit. I think the new proposed
15 standard neither diminishes nor enhances that notion.
16 It will still be left up to the people executing and
17 the auditor to look over the shoulder of the
18 preparers and make sure the standards are properly
19 followed.
20 So to answer the question, I guess I'm
21 sort of neutral on the second one.
22 MS. VIRAG: Ted, we had more input. I

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1 wanted to check back in with you. Did you want to
2 continue your remarks?
3 MR. TED WHITE: Maybe I didn't do a good
4 job asking the question.
5 I guess what I'm saying is, isn't the risk
6 in what we're talking about here a risk-based
7 approach? It seems to me that while it is an
8 attractive concept, there is evidence coming from
9 your latest inspection report that it doesn't work
10 right or hasn't worked right. First, is that comment
11 accepted? And what is different about the process
12 going forward? How do we fix that? My personal
13 opinion is that investors are accepting of a
14 risk-based approach and can see this is a way to
15 locate resources to where they're most useful.
16 But any time you have a process that has a
17 lot of judgment calls, then each step along the way,
18 you're relying upon thousands upon thousands of
19 individuals in firms to make these judgment calls.
20 Is the inspection process different such
21 that we can support that? Is there enough in the
22 standard that drives that differently?

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1 Or is there any difference? Is this
2 approach new or is it the same?
3 MS. VIRAG: Sam, do you want to comment?
4 MR. RANZILLA: I didn't think I was next
5 line. Let me try to address Ted's questions. I'll
6 play a little bit off John's comments. Risk-based is
7 nothing new, and maybe to try to put it in some
8 context. Assume that you accept that the
9 implementation of AS-2 was bottom up instead of
10 top-down. We have instances obviously of that
11 happening.
12 That was risk-based. I know there's
13 horrific stories about petty cash and things like
14 that. But the approach if you accept that AS-2 was
15 primarily implemented on a bottom up approach, that
16 was a risk-based bottom up approach.
17 The difference between AS -- a bottom up
18 and a top down is, I mean, sort of obvious. You
19 attempt to come from the top down, and identify
20 controls where you can, say, that covers my risk as
21 opposed to testing a bunch of controls down at the
22 bottom level.

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1 But there's nothing new about risk-based
2 approach. To John's comments, I think there is some
3 concern because there was late in the '80s or some
4 period of time some approach done that way that
5 probably wasn't implemented very well.
6 But risk-based is -- I mean, one, you
7 can't do an audit unless it is a risk-based audit.
8 There's simply not enough time in the day to do that.
9 But the risk-based is now just the focus, the focus
10 of coming down versus coming back up.
11 MR. TAROLA: I just wanted to comment on
12 this part as well. I think the proposed standard is
13 directionally sound. Where I think it does need
14 guidance is in assessing risk and how one should
15 assess risk from an auditing and financial reporting
16 perspective.
17 And in my view, it's more of an enterprise
18 risk assessment than a failure of the accounts being
19 correct. Understanding the investor expectation,
20 understanding concerns of rating agencies,
21 understanding the strategy of the company,
22 understanding the governance structure, understanding

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1 how the finance organization works and its
2 effectiveness and competencies and the qualitative
3 factors affecting risk, I think could be built out
4 more in the proposed standard and serve as some
5 guidance to auditors in making the risk assessments.
6 And then in turn making the judgments as to how and
7 to what extent they might be performing auditing
8 procedures.
9 But to Craig's point, I think that the
10 external implications to risk are important. And
11 from an insider's point of view, an officer certifies
12 financial statements, I look at our risk more from an
13 enterprise perspective than purely from a financial
14 accuracy perspective. I think you could build that
15 out.
16 MS. VIRAG: Jeff Steinhoff?
17 MR. STEINHOFF: Going to Ted's point,
18 risk-based approaches are not rocket science. I
19 think Sam was saying that.
20 I think people know how to do it well. It
21 shouldn't be difficult to do it well. When this
22 group discussed this at the time that AS-2 was being

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1 contemplated, there were a number of examples cited
2 where risk-based approaches didn't work well.
3 And I viewed all those examples as an
4 execution problem. Not a problem with the
5 fundamental nature of it.
6 I agree fully with John's comments which I
7 think should be memorialized somewhere because he hit
8 the nail right on the head. I think there was always
9 an ability to apply risk-based approach even under
10 AS-2. I can understand, however, the reluctance of
11 practitioners to do so, given the very prescriptive
12 nature of the standard and the fact that they were
13 being inspected against that standard.
14 And the fact that there had been a lot of
15 problems in recent years.
16 I think the real key is that a risk-based
17 approach does require hard work. It does require
18 very knowledgeable people to make the proper
19 judgments up front. There's skill required. Rigor
20 is required.
21 And I think it is just very, very key that
22 the profession, we all get it right.

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1 We at the Government Accountability Office
2 have been applying a risk-based approach in our
3 audits from the beginning and we are strongly
4 supportive of the way the PCAOB is going here on this
5 and we were really pushing for that at the time of
6 AS-2.
7 But it is really up to people to learn
8 from some of the experiences of the past where this
9 was at times used as sort of a proxy for reducing
10 audit scope. We'll kind of fly through and we trust
11 top management and everybody is good on top here and
12 they're nice people; so we don't have to do a whole
13 lot of work here.
14 And that I think won't work real well
15 and -- but if we do apply it, in a rigorous manner, I
16 think it will, in fact, provide the same level of
17 assurance and provide for a much more effective audit
18 because you'll be focusing on the more important
19 things.
20 MS. VIRAG: Thank you, Jeff.
21 Ed Trott.
22 MR. TROTT: I think AS-2 was an

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1 implementation issue. My biggest concern is, are you
2 appropriately trying to get the right message out?
3 I would say that many people I expect look
4 at AS-5 as a relaxation of the goals and the needed
5 effort. I know that is not your objective, but I
6 think the problem is that in issuing AS-2, you've not
7 have done it that way. If I was going to do
8 anything, I would have amended AS-2 not to make this
9 look like, well, we learned our lesson, we're going
10 to significantly back off of the need to be diligent.
11 And I think that's the message that many
12 people have gotten from your actions.
13 I hope that you can work with the firms,
14 work with the SEC, work with FEI, work with other
15 organizations to emphasize AS-5 is not a back off of
16 the objective, AS-5 was to try to incorporate the
17 so-called efficiencies that should be learned in
18 implementation.
19 Unfortunately, I think your actions are
20 likely to be misinterpreted and deemed to be a
21 back-off of the objective that you, one, set with
22 AS-2 and that you're trying to articulate in AS-5.

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1 But that's going to be a hard message to get through
2 to those persons who, quote, are doing this basically
3 from the 50,000-foot level and that influences
4 behavior and everything else.
5 MS. VIRAG: Arnie Hanish?
6 MR. HANSEN: Let me try to touch on a few
7 topics. First of all, let me say I believe that
8 AS-2 -- I'm sorry, AS-5 is a giant leap forward in
9 trying to deal with some of the issues that had been
10 discussed and addressed over the last several years.
11 I think that it does -- as I think John
12 was saying -- I believe that it was an implementation
13 issue. I believe that the opportunity for the
14 auditor to extend the use of appropriate judgment was
15 there, but that it was an issue at the individual
16 local practice level where it wasn't consistently
17 applied.
18 I believe that -- maybe using an example
19 of a risk-based approach and judgment, one of the
20 examples that I like to use internally all the time
21 is in the payroll area. Very seldom do you -- at
22 least we don't find in ours, as well as large

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1 organizations, a fraud being perpetrated or a
2 material risk that there was a financial misstatement
3 in a payroll area.
4 But I believe that in at least the way it
5 had been previously interpreted, since that was a
6 significant level, a material level of cost and
7 expenses embedded in our financial statements as well
8 as the costs of our products, the auditors felt
9 obliged to spend a significant amount of time testing
10 payroll, as an example. The flows of payroll.
11 But the risk that that was ever going to
12 produce a material misstatement was extremely low.
13 I believe this new standard, at least in
14 the dialogue I've had thus far with our auditors, we
15 can try to get out of the trenches and get up to
16 higher levels and focus on the areas where embedded
17 within, for example, the cost of our products,
18 focusing in on the existence of inventory or how the
19 costs are developed of those products that we can
20 spend more time from an auditing standpoint focused
21 where is the real material risk that a financial
22 statement failure would occur, as opposed to worrying

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1 about the transactional activity as to whether or not
2 we pay 20,000 people appropriately on a semi-monthly
3 basis.
4 I think that to me is where the
5 judgment -- auditor judgment needs to come in and be
6 applied in this new standard. It is truly looking at
7 where are the risks of a material financial
8 misstatement. I believe it affords us this
9 opportunity to have the appropriate dialogue.
10 MS. VIRAG: Joe Carcello?
11 MR. CARCELLO: I want to maybe second what
12 Ed said and directly get at your second question
13 there.
14 An overarching concern I have is what I
15 view as the overemphasis on efficiency. Some people
16 ask me where I'm getting that from. Let me be
17 specific. If you look at page 3, first full
18 paragraph, second sentence, now I quote, the board
19 agrees that auditors should perform internal control
20 audits as efficiently as possible for companies that
21 are required by the SEC's rules to obtain an audit
22 report on internal control.

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1 And then if you go to the SEC's exposure
2 draft, they are advocating increased reliance on
3 management judgment. That may work well where
4 management is competent and honest. In situations
5 where management lacks integrity, i.e., fraud
6 situations, increased reliance on management's
7 judgment is going to result in management's opinion
8 being totally worthless.
9 It seems to suggest the need for greater
10 auditor assurance, but the focus on AS-5 is on
11 increasing efficiency, not necessarily effectiveness.
12 In my view, the role of a regulator historically is
13 to prescribe a certain level of performance,
14 effectiveness, that must be met by the regulated
15 entity. Concerns with efficiency are best met via
16 market tests. If Ernst & Young spends too much time
17 performing the audit, fire them. Hire another firm.
18 Focusing on efficiency --
19 (laughter.)
20 -- or any of the other firms.
21 Focusing on efficiency, especially by a
22 regulator, can easily lead to insufficient audit work

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1 and a decline in audit quality which is your second
2 question.
3 MS. VIRAG: Bob Kueppers.
4 MR. KUEPPERS: A couple points. We all
5 want to make sure Ted is satisfied with his good
6 question about risk-based. Let me point out that the
7 judgment areas don't -- aren't limited to the initial
8 assessment of risk.
9 And I say initial, because let's assume
10 you're doing a first audit and you go through your
11 process to try to concentrate your testing in areas
12 of greatest risk. As you go about the work, you will
13 find your initial assessment needs to be adjusted and
14 updated. Some of the areas you viewed as risky might
15 turn out to be otherwise and some other categories
16 you had in a low category might contain more risk as
17 you learn more and perform related testing.
18 The judgment cascades throughout the
19 entire standard including the decisions on the
20 nature, time, and extent of procedures that flow from
21 that initial risk assessment.
22 And I think that one of the things you

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1 might speculate about is if you don't use a
2 risk-based approach, what's the alternative? The
3 alternative would to be somehow test across the span
4 of the population, if you will, at the same level.
5 And I think over time, the profession, the GAO,
6 others have used a risk-based approach appropriately
7 to focus the testing where the greatest risk lies.
8 But that is a -- that's an analysis that needs to be
9 updated as you go through the course of an audit as
10 you learn more.
11 Second point I have is as to the
12 sufficiency point, I don't think, at least from my
13 firm's standpoint, and I think probably the other
14 major firms as well, that we're getting the wrong
15 message. I think that the thing that troubles me
16 about the efficiency point and wouldn't bother me to
17 see it in adopting release language and things like
18 that, I don't think it is a good idea to have it
19 embedded in a standard.
20 I think standards generally should --
21 historically and in the future -- should represent a
22 minimum level of work that needs to be achieved.

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1 When you introduce efficiency as a requirement, that
2 may work most of the time, but we all have situations
3 that are frankly difficult. And you may not get
4 their efficiently, but you may get to the end of the
5 journey as is needed.
6 If in fact this doesn't protect investors,
7 then we wouldn't support the standard. And I think
8 that all that said, the reason we're supporting the
9 standard as an improvement is we think it will be
10 easier for our partners to implement with the
11 appropriate guidance from the firms. And I think it
12 does preserve the investor protection requirements in
13 the Act.
14 MS. VIRAG: Randy Fletchall?
15 MR. FLETCHALL: First, Joe likes to do a
16 lot of research. In research, you come up with
17 hypotheticals. I'm sure what he was giving was a
18 hypothetical about a particular audit firm doing too
19 much work and the market would react.
20 This goes back to Ted's question, but to
21 what Bob said, and Craig said about the need to
22 understand the business and industry in which an

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1 audit client is operating. That is clearly important
2 to a risk assessment.
3 What you have to be careful about is
4 thinking that is in lieu of actually understanding
5 how the financial statements get prepared and where
6 there might be errors or material errors. So that's
7 kind of incremental. I just don't think we should
8 get into the thought that if I understand the
9 business, I understand the industry, to Craig's
10 point, I don't see anomalies, therefore I conclude
11 everybody is right.
12 Clearly if you see anomalies, that
13 requires work to determine if you have a problem. As
14 we talked -- Sam mentioned, look how we do
15 methodologies over the years. If we got into
16 problems back in, say, the late '80s or '90s, it was
17 trying to take too much of the fundamental out and
18 focus on if I know the business, I know the industry,
19 the company looks healthy, maybe I've done an audit.
20 That's not necessarily the case. That's where we had
21 problems. Yes, it is important. It is essential in
22 an audit to understand the business of the company

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1 and where it operates within its industry, but you
2 can't infer from that that therefore the financial
3 statements are correct and I don't have to do other
4 work.
5 MS. VIRAG: John Kellas?
6 MR. KELLAS: First of all, I want to say
7 without commenting on the details, the general
8 direction towards a slightly more principled,
9 slightly higher level standard seems to me to be
10 absolutely right. I think my general approach would
11 be to start at as high a level as is consistent with
12 improving and creating good practice and necessarily
13 make the standard more detailed if inspections, for
14 example, indicate that that is necessary.
15 There was a comment about judgment and the
16 need not to second-guess the judgment of the auditor.
17 I think that there's obviously truth in that. It is
18 true, judgment should be allowed to flourish. At the
19 same time, I know regulators elsewhere are concerned
20 that judgment is used almost as a trump card.
21 One point we are keen to make is auditor
22 judgment is not that trump card, but it is to be a

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1 reference to what other experienced auditors might do
2 in similar circumstances. So there's no one answer
3 to anything. But on the other hand, there must be
4 ranges of reasonable and maybe there's something that
5 ought to be written into the standard along those
6 lines.
7 Just picking up the efficiency point, it
8 is right that standards are concerned with quality
9 first and foremost rather than efficiency. I think a
10 standard setter, any regulator, cannot ignore
11 efficiency. And if one of the problems with AS-2 has
12 been inefficient implementation, it may not be just
13 dealt with in the way that Ed indicated by amending
14 the current standard. But it may be that there's
15 something about the current standard that breeds a
16 certain inefficiency, albeit that all the right words
17 are in all the right places.
18 Sometimes it is easier to start again and
19 to indicate that fresher approach, provided you
20 accompany it with the message that Ed was concerned
21 about, that you should not be portraying this as some
22 how a rather relaxation, but a different approach to

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1 a quality audit that will promote efficiency while
2 maintaining the quality.
3 MS. VIRAG: Lynn Turner?
4 MR. TURNER: I'd echo the comments that
5 Dr. Carcello made as well as those that Ed made. I
6 think -- as well as the question that quite frankly
7 Ted asked, but never got an answer to.
8 We have been doing these type audits for
9 the last few decades. SAS 55 came out in 1988. It
10 is not like it is something new. It is the exact
11 approach we used on many of the audits that have
12 failed miserably and resulted in mega claims against
13 auditors, not without reason.
14 So I think there is a concern, because
15 when I compare the language in SAS 55 with the
16 language in this particular document, what I find
17 this is document is similar, but if anything lacks
18 some of the guidance in the old AS-5 and certainly
19 the guidance in the old audits guide. I know the
20 auditing standards board did a nice job of trying to
21 update that recently. Maybe that's something that
22 needs to be taken a look at as well.

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1 But it is a continuation of exactly what
2 we've been doing, and there is nothing in there that
3 indicates really any significant change despite the
4 fact that there was a fairly thorough study done in
5 the '98, '99, 2000 timeframe in the O'Malley panel
6 report. If you go back and read the O'Malley panel
7 report, all the major firms sitting around this table
8 at that point in time did indicate they weren't doing
9 this notion of top down and stop, they were in fact
10 doing a full top down risk assessment.
11 And the O'Malley panel came back and found
12 that there were two problems, a couple of problems
13 with that standard. One involved the attitudinal
14 issue and something has to be changed in the standard
15 if we're going to address attitudinal issues and how
16 auditors were approaching the risk assessment, which
17 clearly hasn't happened because if you look at the
18 last 4010 report, we see people not showing up for
19 the brainstorming session required by the audit
20 standards board.
21 So clearly we haven't got that issue
22 addressed yet. Yet that's a major hole and

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1 shortcoming in this document.
2 I think the other shortcoming which
3 O'Malley aptly pointed out was the fact that there
4 are procedural issues that haven't been adequately
5 addressed in the standard nor in this one. And to
6 that point, I really would like to echo what Craig
7 said. I think this standard is still written up by
8 and for auditors and doesn't consider adequately how
9 you really get to some of these issues.
10 The points Craig made about the auditors
11 need to get outside their little box of ticking and
12 tying and need to look at things like analyst's
13 reports and other things that, what's going on with
14 that company and the market price and understand
15 where the market is on that.
16 If you look at the cases, you know, in
17 some of the major cases in Micro-strategy cases, the
18 enforcement release notes, it was a Forbes article
19 that highlighted the problem. The auditors didn't
20 find it, yet a Forbes writer did. At Ride-Aid, the
21 auditors didn't find it, but an SEC staff review from
22 Washington found it. It is because they aren't

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1 looking at the type of things that Craig mentioned.
2 That's a gaping, gaping hole in this very
3 particular document. And if you go out with the
4 document as it is, especially with the tonal issues
5 that Ed talks about, because there is no question in
6 the most recent months even the Colorado state
7 society came out with a summary of this thing and
8 headed it up, PCAOB reduces testing.
9 There's no question how this thing is
10 going to be perceived by the public in general.
11 That's quite frankly what I think your goal is. If
12 that's your goal, you need to tell the world. But if
13 that's the case, then I think you're going to have
14 the same thing we had for the last two decades; and,
15 eventually, the PCAOB will be held accountable for
16 that.
17 This is more than just, quite frankly,
18 about accounting and auditing. We've done some of
19 that research. Ours isn't hypothetical, we actually
20 use your clients, Randy, and they provide us
21 fantastic data, great data to work off of. But when
22 you look at the companies that have gone through

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1 these restatements and gone through these material
2 weaknesses in the last year and going back to 2004,
3 that population of companies have underperformed the
4 market indexes by 18 to 20 percent.
5 And for this population of companies to be
6 underperforming that index by that amount, that is
7 humongous.
8 The notion that we're relaxing and may not
9 see that information getting out to investors so they
10 know to stay away from those companies would be a
11 travesty. Because that is a big cost and a lot more
12 cost in terms of tens and hundreds of billions of
13 dollars than what these audit fees even remotely come
14 to.
15 MS. VIRAG: Ted White.
16 MR. TED WHITE: Thanks. First, to Lynn, I
17 would echo what Joe and Harold said so eloquently.
18 While efficiency is a fine term, that should not be
19 the preeminent purpose here.
20 I think from an investor viewpoint, of
21 course, we want our money spent wisely. But the
22 quality of the audit is first and foremost. I

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1 personally found it very interesting that the
2 pressure back on the system, particularly on the SEC
3 and even here has been from the cost standpoint, not
4 from the people paying the bills. In my opinion,
5 investors ultimately foot the bills. You have not
6 heard widespread complaints from investors about the
7 cost of audits. Sure we want it efficient. But
8 effective has to be number one. My perception is the
9 staff has been aligned with us on that.
10 Now, to the question earlier. I think the
11 fairness part of it has been answered. I think I
12 heard these people's opinion that it is an
13 implementation problem or it has been an
14 implementation problem in the past.
15 The second part of my question, I would
16 like some perspective from others here and from the
17 staff as to what's different. If that is truly the
18 case, do you agree with that? What is different now?
19 Is the inspection process alone something that fixes
20 that? Is the standards -- differences in the
21 standard fixing that? I was alarmed by what Ed said.
22 If there's a perception the PCAOB is relaxing

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1 standards, that's -- that doesn't seem right to me.
2 Maybe that's a bad perception, but -- maybe I could
3 open that question up.
4 I'd like to hear from the staff if you
5 feel you have addressed those problems from an
6 implementation perspective, should we be comfortable
7 with that?
8 MR. RAY: I'd be happy to make a couple of
9 comments with regard to your question.
10 Is this different? I think the question
11 is probably asked -- in substance, I would say it is
12 not different. I would say what we've -- are
13 attempting to do is really emphasizing more in this
14 standard the focus on risk and the focus on judgment.
15 And the attempt is to try to appropriately, again
16 emphasizing appropriately, permitting auditors to
17 exercise judgment in performing the internal control
18 audits.
19 I think what is different fundamentally,
20 what is different about the environment today is the
21 existence of the PCAOB and its inspection function.
22 We now do have an inspection, a quality inspection

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1 function that is independent of the auditing
2 profession. And so I think that that is a very
3 significant factor to be considered as we complete
4 our rulemaking in this standard.
5 MS. VIRAG: We'll go to Craig Omtvedt.
6 MR. OMTVEDT: Thanks. I just want to add
7 a couple of comments. First, I think in terms of the
8 concern about this being viewed as a relaxing of the
9 standard, I can tell you that for those of us out in
10 the field, no one views it in that light.
11 I think universally we all view it as an
12 opportunity to have better quality audits and be more
13 effective. I think one of the concerns with AS-2 and
14 anybody who has done any degree of auditing will tell
15 you if you are looking across the board at everything
16 equally, you are going to dilute down your effort and
17 you're not spending your time in the areas that are
18 critically important. I think, again, the
19 modification you are making here is going to allow
20 for much more qualitative audits.
21 I personally think one of the things we
22 are all grappling with here -- and I want to lay this

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1 out a little bit -- I think we have an audit approach
2 today, playing off of Joe's point, that assures the
3 good people are effective in trying to do it right.
4 I don't think we have an audit process today that
5 helps detect the bad people intent on doing it wrong.
6 And by that I say that as we look at the
7 audit approach today, first we look at, do we have
8 control processes in place to see that transactions
9 are recorded properly?
10 Do we have a financial organization with a
11 sufficient understanding of GAAP to prepare the
12 statements in accordance with GAAP?
13 And at the end of the audit process, we
14 get opportunities to improve our control processes
15 and correct errors. Again, the people who are trying
16 to do it right get assistance in getting it right.
17 But when you have a situation of
18 management override and outright fraud, I would offer
19 up that the audit approach as it stands today is
20 highly ineffective in detecting those kinds of
21 situations.
22 We had somebody be here -- I don't

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1 remember his name -- who six months ago raised the
2 whole issue of how are we approaching the whole
3 aspect of fraud in the risk assessment process in the
4 audit process.
5 And I would suggest to you that until we
6 get that sorted out and get that right, all you're
7 giving people in the certification is comfort that
8 those who are trying to do it right got it right and
9 they've given you statements in accordance with GAAP.
10 I would offer up from an investor's
11 standpoint, I would suggest that the certification
12 should be -- and these are my percents now, so I'm
13 doing something ballpark -- the certification is
14 probably -- should be 30 percent, that the financial
15 statements are correct and proper and in accordance
16 with GAAP; and should be 70 percent assurance that
17 there isn't a fraud.
18 Now, I accept the fact that people aren't
19 going to catch everything. But I would say to you
20 today, the audits are woefully inept in detecting
21 fraud.
22 MS. VIRAG: We have time for two more

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1 commenters, Charles Noski and Cynthia Richson.
2 MR. NOSKI: I am probably one of the few
3 people who has listened to everything this morning
4 and can say I agree with almost everything I've
5 heard. I've been an auditor. I've been a preparer
6 of financial statements.
7 Today I sit on several boards of directors
8 and chair two audit committees. I am listening
9 through my filter as an audit committee member and
10 trying to think about how AS-2 and AS-5 affect what I
11 do and how I think about the work of the auditors
12 whose client I am.
13 The thing that strikes me that is going to
14 be important if you go forward and adopt AS-5 is that
15 there needs to be a much more robust dialogue between
16 the independent auditors and the audit committee
17 about the risk judgments and the risk assessments
18 that the auditor is making, because my concern will
19 be -- as I listen to this -- and, of course, what
20 I've heard from both preparers and from audit firms
21 is that AS-5 is actually viewed as an expectation for
22 a much reduced level of work and more risk-based.

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1 And I, too, can remember back to the '80s and '90s
2 where that was code for doing less work and being
3 more competitive and reducing audit fees.
4 Having been a preparer and an audit
5 partner at one point in my career, I have different
6 perspectives on audit fees. As audit committee
7 chair, I have different perspectives on audit fees
8 because I am now more interested in the effectiveness
9 as well as the efficiency in the audit.
10 So I do think that as you think through
11 the communications between the audit firms and their
12 clients, the audit committees, that there should be a
13 much more robust dialogue about those judgments
14 because as audit committee members and as board
15 members, we are focused on risk assessment and risk
16 management and we spent a lot of time looking at,
17 frequently at some companies, looking at the
18 performance of audit companies versus others, and
19 trying to understand why we are better or worse than
20 the performance of others and challenging management
21 to explain to us why the financial statements reflect
22 the reality of their business and their performance.

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1 So please don't forget the audit
2 committees and our needs as you reflect upon the
3 requirements that you're proposing in AS-5.
4 MS. VIRAG: Thank you.
5 Cynthia Richson.
6 MS. RICHSON: Thank you. The discussion
7 this morning has been very insightful and very
8 interesting. I agree with a lot of what's been said.
9 But I do think Ed sort of hit it on the head.
10 I've been talking to a lot of audit
11 committee members, independent directors, and I think
12 the perception out there is really that the PCAOB is
13 relaxing the internal control standard and the
14 testing standard; and I think that's a very big
15 problem.
16 I think part of it -- even I, when I first
17 learned about this -- was surprised that the PCAOB
18 didn't say we've got two years of inspection reports
19 under our belt, of which, of course, only part of
20 that is public and parts are not. So we don't have
21 the full story even sitting here. But that they
22 weren't going to tweak it to make it more effective

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1 and efficient. Instead it is a brand-new standard.
2 I think that's feeding into the perception
3 that this is -- the companies have complained loud
4 enough and often enough that we need to do something
5 about this crisis. And in talking to audit committee
6 directors and members, basically I hear horror
7 stories -- and these are widely circulated -- about
8 how the auditor came in and spent the entire day
9 looking through my day book to make sure that the
10 meetings I said happened really happened. In other
11 words, a complete waste of time.
12 And so you say, gee, that doesn't make any
13 sense. That strikes me as being very wasteful. On
14 the other hand, some good points were made by Ted and
15 Lynn.
16 I don't think any investor who ultimately
17 bears the burden of cost of these audits has
18 complained. For the most part, it is about audit
19 quality and that's where the focus ought to be.
20 When I hear the focus on the new proposed
21 standard is business efficiency, while we're all very
22 much in favor of efficiency, I think the bottom line

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1 really needs to continue to rest with quality of
2 audit.
3 That's where the focus needs to be. And
4 if implementation really is the problem, that's where
5 we ought to be focused. What I'm hearing was the
6 experience of the '80s when risk-based assessment was
7 out there and used as a code word for doing less
8 work. I keep hearing about inexperienced auditors --
9 which we heard at other SAG meetings are doing all
10 the work, young people out of college. I think that
11 needs to be addressed. And the fraud standard.
12 We are on the heels again of the
13 back-dating stock option scandal. There has been no
14 breathing room of generally the PCAOB is being
15 allowed to do its job properly, it really is
16 functioning as independent of the audit profession,
17 accounting profession and we're getting it right.
18 Incremental steps, we learn as we go
19 through inspections and other processes. I encourage
20 you to keep public perception in the back of what you
21 do as you go forward.
22 MS. VIRAG: Do you want to comment?

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1 MS. GILLAN: I should start out by saying
2 the views I express today are my own and not
3 necessarily the board's. I am a little bit perplexed
4 at some of the statements I'm hearing. I am the
5 first to acknowledge that perception of what one is
6 doing can sometimes be as important as what one is,
7 in fact, doing.
8 And so when I hear that the perception is
9 that the PCAOB's proposed standard was intended to
10 water down or to relax standards in a way so that
11 there is not an emphasis on quality, that concerns
12 me.
13 However, at the same time, I'm a little
14 bit at a loss to understand why people haven't read
15 the statements that the board made when we proposed
16 the standard, which was that our definition of
17 efficiency is, per se, doing the high quality audit
18 with the least resources possible.
19 So that is the focus.
20 Cindy, when you say that some people think
21 our focus is saving costs, no, it is not. It
22 absolutely is not. I'm not sure how much more clear

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1 we can say that, but the fact there is so much
2 misperception out there -- and I hope this comes out
3 in comment letters, please send your comment letters
4 in soon -- tells us that we probably need to look at
5 how we say things.
6 But I guess I just didn't want the record
7 to go by -- and I know there are reporters in the
8 audience -- with it being unrebutted that in this
9 board member's mind, the proposal was not intended to
10 focus on saving costs, was not intended to water down
11 in any way the standard. If we said it wrong or got
12 it wrong, I hope commenters will let us know that.
13 MS. VIRAG: We're going to go ahead and
14 give this a few more minutes.
15 Christianna, do you want to talk?
16 MS. WOOD: First, I want to echo the
17 comments of my fellow investors that as one of the
18 larger pension plans in the world, we are willing to
19 pay whatever it is, whatever it takes to get audit
20 statements right.
21 And also the comments about identifying
22 gross fraud. I mean, that ultimately is the largest

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1 cost that we face. While there is plenty of talk
2 about AS-5 being a back-off or a back down, I think
3 really I appreciate Kayla's comments that we need to
4 recognize there has to be a balance. I want to say I
5 support the PCAOB in all of their efforts to find a
6 balance and to get this right.
7 But what would really be the test is in
8 the future and how they respond to the audits in the
9 next few years, and the proof of the pudding will be
10 sort of right there in how they respond to whatever
11 changes or perceptions or changes in behavior that
12 are in the marketplace.
13 I think it is incumbent upon them to hold
14 to what they believe they've done which is to try to
15 find the right balance.
16 But I do want to say that -- you know,
17 acknowledge the perceptions, but say that ultimately
18 the PCAOB will have to send the right messages to the
19 marketplace. And I want to support them in being
20 firm on the effectiveness side as opposed to the
21 efficiency side of the balance.
22 MS. VIRAG: I really mean it this time.

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1 We're going to take two last comments and then cut
2 this discussion off.
3 Gaylen and then Arnie has a comment, and
4 then we'll be done.
5 MR. HANSEN: I do agree with you. I don't
6 think we have gone overboard with that. I can say
7 from a CPA perspective that this standard is telling
8 us that we should apply more judgment. But I just
9 went through an inspection where almost every single
10 comment was addressed and critical of the judgment
11 that we did apply.
12 So I think there's a balancing act and
13 that is where the inspection process comes in to
14 play.
15 And I -- then just briefly, we had some
16 discussion about the audit committees and their
17 oversight function, and I think it's very important
18 that they be utilized properly. And in this process,
19 it can't be overstated how important that that is.
20 I've seen a huge improvement in the
21 functioning of audit committees and the role that
22 they play. But on the other hand, I don't think you

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1 can expect audit committees to ever do -- to do
2 everything that -- to identify management override
3 and reduce to an acceptable level what might be going
4 wrong within these companies.
5 You can't expect the audit committee to be
6 the back stop here. And so if that's what we have in
7 mind, I don't think that works. And especially not
8 some of the smaller filers where some of them don't
9 have audit committees to rely on. I think that we
10 need to kind of rethink that.
11 MS. VIRAG: Arnie?
12 MR. HANISH: I guess -- I'm trying to
13 figure out how to frame this.
14 I find it regrettable that many people
15 around the table are trying to sort of tear away at
16 what I think the staff and the board have done an
17 admirable job of trying to address, issues over the
18 past several years that have been brought forward.
19 I would challenge many of the people
20 around the table to maybe try to get into the
21 trenches and understand where some of the criticisms
22 have come from from the companies. It is in our best

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1 interest as a company to make sure our investors have
2 the utmost confidence in our financial statements.
3 We look to our internal processes and
4 people preparing those financial statements to ensure
5 those financial statements are accurate and present
6 fairly the financial position and condition of our
7 companies.
8 But the way these audits were implemented
9 is where the rub is. And I just really don't know
10 how many of you have ever in recent years been in the
11 trenches to see the incredible level of detail we are
12 being put through.
13 We can talk all we want at high levels
14 about risk-based approach. But put yourself in the
15 position of us within the company having to deal with
16 some of the -- what I'll call ridiculous questions
17 that were being posed to us because there wasn't a
18 lot of judgment being exerted or commented on the
19 part of many of the auditors.
20 I think these words enable us to have the
21 appropriate dialogue with the auditors to get them to
22 focus and help them focus on areas where there is the

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1 greatest risk.
2 And I guess maybe we need to -- as SAG
3 members -- have an auditing 101 lesson for some of
4 the members around the table to get people to really
5 experience what some us who are sitting here as
6 preparers have really complained about for the last
7 several years.
8 We're willing to pay whatever it takes to
9 create a situation and an environment where the
10 investors truly do have confidence. But the level of
11 detail and the lack of focus on those areas where
12 many of us believe where there was a significant risk
13 of a material misstatement was really misplaced. And
14 I think this enables us to get the focus in the right
15 direction to provide what you all who are investors
16 want, the high quality audit that's efficient and
17 effective.
18 Thank you.
19 MS. VIRAG: At this point, I'm going to
20 put up the questions for the next session and people
21 can be thinking about those and we can kind of move
22 on to that.

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1 I see we already have a tent up. I'll
2 call on Damon.
3 MR. SILVERS: I apologize. I'm still on
4 the last session. I hope you'll indulge me. I think
5 Arnie's comment about who's in the trenches deserves
6 some sort of response.
7 In my capacity at the AFL-CIO, I have a
8 variety of duties. Among them has been advising a
9 preparer who was attempting to comply with 404, and
10 doing so voluntarily.
11 And I am deeply aware of what Arnie is
12 talking about. I have experienced it firsthand. The
13 AFL-CIO and I personally have been very determined in
14 the dialogue about section 404 and AS-2 to be clear
15 that we sympathize with much of what we have heard
16 from the preparer community by what appeared to
17 people of good faith about unnecessary burdens being
18 imposed.
19 And for that reason -- among others -- we
20 were supportive of the general direction which the
21 PCAOB and the staff took in considering changes to
22 AS-2. And I think if you Google or whatever our

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1 comments in relationship to this process, you will
2 see that's where we have been.
3 And I don't think we're alone in that.
4 The Council on Financial Investors is in a similar
5 position. I think most thoughtful, long-term
6 investors had a similar point of view. Unnecessary
7 expense and unnecessary distraction from the business
8 of running companies is not in our interest.
9 What's happened, I think in the last few
10 weeks as people have -- as people have read carefully
11 the proposed draft standard is that -- and I think
12 this reflects perhaps the tone of Arnie's comment
13 about people tearing things down.
14 What's happened here is that a number of
15 concerns are being raised from a number of expert
16 quarters, more expert than I -- academics,
17 auditors -- about what the implications are of
18 certain phrases in the proposed draft standard.
19 In particular, the implication surrounding
20 the question around the issuance of the reliance on
21 the work of others and on the ability -- on whether
22 or not all -- either issuers or auditors are being

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1 instructed, encouraged, hinted that merely the
2 conclusion that somebody at the top of the company
3 seems like an honest fellow is going to be enough
4 to -- is going to be enough not to have to actually
5 look at actual controls.
6 I'm not enough of an expert to be able to
7 get deeper into these things, but I keep getting
8 ambushed by people who I think are to my right and
9 turn out to be on my left on this and it makes me
10 uncomfortable.
11 I want to reiterate my support for the
12 work of the board and the staff around this area
13 which I think has been admirable, and has done great
14 credit to the board and the expectations Congress had
15 for the board when it put it in place. These issues
16 being raised are serious ones and are what the
17 comment period is for.
18 We believe that the foundations, the
19 conceptual pillars, so to speak, of what is being
20 done here are correct. The board and staff need to
21 be vigorous in rooting out any of these hints that
22 under a new AS-2 or AS-5 auditors or preparers are

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1 going to be allowed to look the other way.
2 MS. VIRAG: Joe Carcello.
3 MR. CARCELLO: Before I make my next
4 comment, let me reiterate something I said to some
5 people yesterday. I think on balance the standard is
6 a good standard. But I don't think we bring a whole
7 lot of value if we come here today and just applaud
8 you.
9 So what I'm trying to do is point out
10 things that I think are at least worth thinking
11 about. And so that's what I'm trying to do.
12 One comment I have related to this
13 question and this again interacts with the SEC's
14 guidance. The SEC's guidance talks about a strong
15 indicator of a material weakness and ineffective
16 oversight of financial reporting by the audit
17 committee. And I clearly disagree with that. But no
18 guidance is offered in either the SEC exposure draft
19 or AS-5 as to what ineffective oversight looks like.
20 I think this is particularly problematic
21 because no evidence -- no evidence that I'm aware of,
22 maybe you guys are aware of some -- that auditors are

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1 proficient in evaluating audit committee oversight of
2 financial reporting.
3 And there's an actual conflict, given that
4 the audit committee now has the authority to hire,
5 fire, and compensate the external auditor.
6 Also relating to company level controls is
7 the whole discussion we had this morning by a few
8 people about fraud. I would agree with what Craig
9 said. I think this is a major issue.
10 In your exposure draft, there's a quote
11 from Craig Jonas that there needs to be increased
12 controls on fraud. I clearly agree with that. I
13 think AS-5 should have a more robust discussion of
14 this issue or the PCAOB should accelerate its
15 possible reconsideration of SAS 99, especially given
16 the numerous -- and as Lynn said -- really
17 rudimentary deficiencies documented in the board's
18 recent 4010 report.
19 MS. VIRAG: Okay. I forgot to read the
20 question for everybody. The company level controls
21 discussion is based on the question, does the
22 proposed standard adequately articulate the

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1 appropriate consideration of company level controls
2 and their effect on the auditor's procedures?
3 Bob Kueppers?
4 MR. KUEPPERS: I didn't think you were
5 serious about this question. I was going to answer
6 the last one. So I might as well take the license
7 you've given me.
8 I guess I want to make one point. Maybe a
9 final point hopefully on this issue of tone.
10 If you compare AS-2 and the exposure draft
11 AS-5 and look at things like, well, principle
12 evidence is gone, a large portion disappeared, you
13 might be able to -- you could turn that to be that we
14 don't have to do much work in order to issue our
15 opinion.
16 But I'm not troubled by that simply
17 because where that leaves us as auditors is that we
18 need to have sufficient competent evidential matter
19 to support our opinion. That is true for the
20 financial statement audits. It is the same standard.
21 By introducing, as AS-2 did, new terms,
22 you know, I think all of that does not signal to me

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1 we should greatly reduce work because now it is no
2 longer required that we have evidence.
3 It is in there. It is in the body of
4 standards that we have to comply with. I do recall
5 Kayla's point sitting in the open meeting when the
6 proposal was approved by the board. The tone of the
7 comments by each of the board members individually,
8 some of the questions of the staff I think were --
9 will resonate with me. It was not about dumbing down
10 AS-2. It was not all about cost. It was trying to
11 strike that balance between preserving the quality of
12 the audit, protecting investors, and I still maintain
13 that. I think that the exposure draft largely
14 achieves that.
15 We're going to have thoughtful comments
16 where we think little adjustments need to be made;
17 but on balance, I think it is a very good standard.
18 I don't have any comments for the moment
19 on company level controls.
20 MS. VIRAG: Vin Colman?
21 MR. COLMAN: Obviously, I agree with Bob's
22 comments. Maybe I'll move on to your question as

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1 opposed to going beyond.
2 I think what you're going to see in our
3 comment letter and other comment letters is a couple
4 things. The interaction between the management
5 guidance from the commission and your guidance and
6 perhaps this is one area if you look at the guidance
7 there's some actually very good discussion in the
8 SEC's guidance with respect to the direct and
9 indirect level of company level controls, and the
10 impact that would have.
11 And then you look at the PCAOB standard
12 and where the level of precision -- actually
13 paragraph 43, if you look at paragraph 43, it is not
14 necessarily in the assessment, it is in deciding how
15 much to test. Right?
16 And perhaps that needs to be moved up, and
17 that should be part of your assessment. So that
18 drives the decision-making around, you know, how
19 aligned the company level controls are, your
20 evaluation, and then determine the nature, time, and
21 extent of your procedures.
22 This is a very delicate plan where I think

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1 people could begin to misunderstand similar to a
2 number of the comments that are here where the
3 implementation is going to be key. I think being
4 able to -- it was discussed, I remember, at great
5 length with respect to the COSO for small business
6 and other areas. I think one of the examples came up
7 around segregation of duties.
8 This alignment of company level controls
9 and the level of precision and how it drives the
10 nature, time, and extent of procedures is very
11 delicate. I ask you to continue to think about how
12 it is aligned with the SEC guidance on both sides.
13 So that when we talk about efficiency, the
14 most efficient way to do this is for management to be
15 able to consider what they do and to have the
16 auditor, the whole spirit of being able to understand
17 what management is doing, being able to rely to the
18 extent necessary, and adjust your needs to the time
19 and extent of your procedures.
20 MS. VIRAG: Randy Fletchall?
21 MR. FLETCHALL: Thank you, Sharon. This
22 is an area I have concerns with, too. I think

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1 clearly it is very, very important to any kind of top
2 down risk-based approach that you start early on in
3 the level of company level controls. I think that is
4 clear in the guidance. That sets the right stage.
5 What I am concerned about is similar to
6 something Vin mentioned. Many company level controls
7 kind of indirectly affect whether you get something
8 right. We haven't found in the past that many that
9 directly tell you if you have effective company level
10 controls, if financial statement assertions are
11 correct.
12 So I think it is one of those areas,
13 again, if you clearly have ineffective company level
14 controls, an auditor has a lot of work to do. Where
15 you think you have effective company level controls,
16 again you can't infer that that means transactions
17 are processed correctly and everything is accurate.
18 I made the statement in a SAG meeting, a
19 couple of SAG meetings back when we had a panel
20 talking, going back a few years ago to when we were
21 looking to become more efficient and looking at
22 methodology. We looked around the world, very hard,

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1 to find a lot of company level controls that operated
2 with a precision that if they were in place and
3 operating effectively, you said that gives me
4 assurance the financial statements are correct.
5 My only concern is what you have written
6 is accurate, it sets out the possibility of relying
7 on company level controls. My fear is like an
8 expectation that you actually find company level
9 controls that directly affect the accuracy of
10 financial statement assertions and therefore you are
11 finished and that gives you the efficiency, when I
12 think it is dangerous to rely on company level
13 controls.
14 MS. VIRAG: Sam Ranzilla?
15 MR. RANZILLA: Well, this may be the first
16 time I've ever agreed with Randy Fletchall.
17 I could not articulate it any better than
18 you did, but --
19 MR. FLETCHALL: I agree with that.
20 MR. RANZILLA: But I would say that if
21 there were two flash points in this standard that if
22 I were to look today and think forward to two years

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1 from now, the SAG meeting where we have -- hopefully
2 it is a SAG meeting, not another SEC-PCAOB roundtable
3 on 404 -- but at some point, we're obviously going to
4 have to see how standard 5 holds up.
5 And ultimately, I think the success of
6 auditing standard number 5, from an auditor's
7 perspective, is in two areas: One is getting the
8 risk assessment correctly. Secondly, whether or not
9 company level -- how we deal with company level
10 controls, we're able to discern the difference
11 between those that are directly linked to assertions
12 and those that are indirectly linked to assertions
13 which have very different effects on our audit
14 approach. And then even those that are directly
15 linked to the assertions, is the precision there
16 close enough so that you can ultimately conclude that
17 little or no more work is needed on that company
18 level control.
19 I think how the auditors implement that
20 aspect of AS-5 would depend upon whether we're coming
21 back here in two years having a discussion about the
22 need for more efficiency or the fact that we just

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

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

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

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

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1 than before? What is it that we are looking at to
2 turn around and say that it didn't work?
3 Maybe back again to some of Craig's
4 comments about the fraud stuff. It doesn't seem to
5 be there's enough focus on those controls that deal
6 with fraud.
7 Quite frankly, this gives you almost no
8 guidance, very little definition of what is meant by
9 the control environment where the audit committee is
10 so key. There's hardly a mention of the audit
11 committee in this particular one, and the importance
12 of that role and what the expectations are with the
13 auditor with respect to that.
14 So again, it looks to me like we are very
15 much close to what we've had for the last 20 years,
16 which I suspect will give us pretty much the same
17 result in the next 10 to 20 years. I just wonder why
18 we're going down that path unless we want to repeat
19 history, which it seems like we are destined to turn
20 around and do with this document.
21 By the way, Arnie, I sat on three audit
22 committees and gone through this nitty-gritty in the

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1 last few years and chaired three. I appreciate what
2 you say. I agree that you don't want people going
3 overboard, but this standard is a repeat of history.
4 MS. VIRAG: Cynthia Cooper.
5 MS. COOPER: I agree with most of the
6 comments made. It is dangerous when we rely on
7 company controls to reduce the amount of substantive
8 testing. I think that is one of the reason that some
9 of these big frauds in the past have not been
10 detected through the external audit that I think the
11 frauds like WorldCom, Health South, other big
12 scandals are more likely to be detected through more
13 rigorous substantive testing and more forensic
14 audits.
15 I think it is important to make sure that
16 while auditors are testing company level controls, we
17 don't forget the risks we are trying to meet.
18 Everything should go back to risk in the end, and we
19 should make sure we keep our eye on what these
20 company level risks are.
21 One is management override of controls,
22 collusion that goes all the way to the highest levels

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1 of a company. That's one thing we have seen
2 consistent with most of these big frauds. And in my
3 view, there are very few controls, when you have
4 collusion and override, that will prevent these
5 frauds and detect them.
6 I think it is important we be in agreement
7 with what will prevent these controls, perhaps fraud
8 hot lines to prevent these frauds and make sure we
9 don't use reliance on controls as an excuse to
10 decrease our substantive testing.
11 MS. VIRAG: Kimberly Gavaletz?
12 MS. GAVALETZ: I want to reflect on prior
13 conversations we've had relative to this topic and
14 some of the key points that I think you've tried to
15 include in the standard revision relative to the
16 timeliness and the timing of when you looked at the
17 company level controls.
18 I think one of the points we haven't quite
19 discussed in here was early in the process. We've
20 alluded to it, saying that basically you look at
21 something, decide not to test. I think it is
22 important that some of our prior conversations said

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1 these weren't focused to the end where they might
2 have been able to help with the scoping.
3 I tend to agree if they're really good,
4 you don't have to test. If they're really bad, they
5 do give you signals and that's where you need to go.
6 What I heard was there were a lot of experiences and
7 this might have changed through the last year or so,
8 but a lot of experiences with company level controls
9 being looked at at the tail end of the audit, which I
10 felt was inappropriate and didn't give you the
11 information. They're very informative from the
12 outset. That is an important part you have to have
13 incorporated.
14 I think Lynn touched on it. Whoever does
15 this, it is very important to really look at the
16 company level controls and to discern what's really
17 being told by that. It will take a lot of senior
18 level support to go do the level of substantive
19 testing which I agree is necessary to really get to
20 the foundation of things.
21 It also involves looking at what the audit
22 committee role is. There is a little bit of conflict

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1 in there that has already been pointed out.
2 I think it is a place that does need to be
3 focused on at the right time in the overall -- by the
4 right people and rightly resourced, so you can get
5 the most impact out of it. Otherwise, if you're
6 doing it, I'm not sure what the reason you're doing
7 it. If everybody is external to it and independent
8 of it, it is another check. But a potential leap too
9 far down in the process.
10 MS. VIRAG: John Kellas.
11 MR. KELLAS: Thank you.
12 Perhaps I stumbled slightly over
13 paragraphs 16 and 17. One reason was the reason Jeff
14 raised. I stumbled over the must test. It is wrong
15 to read that sentence without reading the whole of it
16 because you do say that they are important, blah,
17 blah, blah.
18 I think when we were revising the
19 international risk standards a few years ago, we came
20 under a great deal of pressure to acknowledge that
21 company level and overarching controls were capable
22 of providing the auditor the assurance they needed.

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1 At the end of the day, we did resist that.
2 I think our position is much closer to what Randy
3 said at the beginning.
4 They are a very negative indicator, if
5 they're rubbish, but even though they're brilliant,
6 they are unlikely to do your work for you. At the
7 end of the day, the only question to be asked about
8 control is, is it good enough to achieve the
9 objectives I'm looking for.
10 I think you say that in your document
11 somewhere if I remember correctly.
12 That's the point to be focused on rather
13 than -- well, as I say, read the whole sentence. It
14 did make me think maybe the message was a little bit
15 strong on the overarching controls.
16 It is rather like the point Lynn raised
17 earlier about knowledge of business, external
18 information and so on. I think if there's one -- you
19 know, over my years in auditing, one thing I think I
20 came to the conclusion that is really, really
21 important is that the auditor understands the
22 business program.

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1 And so when things go wrong, people aren't
2 saying how could it be that the business failed to
3 provide this. But again, that doesn't do the audit
4 work. It is the basis of good audit. I think the
5 control environment, upper level controls are in
6 exactly the same category. They deserve more focus
7 than they've had in the past.
8 But they are underpinning a good audit not
9 substituting for other matters.
10 MS. VIRAG: I'm going to go ahead and put
11 up the next question. We'll get started before the
12 break. We have 12 or 13 minutes before then to start
13 with comments on scaling the audit.
14 The question is, does the discussion of
15 size and complexity within the proposed standard
16 appropriately describe when and how the auditor
17 should scale the audit?
18 Joe Carcello?
19 MR. STEINHOFF: Yes.
20 MS. VIRAG: I promise to call you next,
21 Jeff.
22 MR. STEINHOFF: I said yes. That was

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1 my comment.
2 MR. CARCELLO: I have a few comments on
3 what you guys are suggesting as it relates to smaller
4 public companies. And one of the things suggested in
5 the exposure draft is that small companies' control
6 objectives can be met through daily interaction of
7 top management. For maybe most companies this will
8 work.
9 What if senior management is corrupt? For
10 example, we know from the research that fraud is more
11 prevalent when the founder is involved with top
12 management. That's been well documented. Smaller
13 entities are likely to have continuing founder
14 involvement.
15 So that would seem to be a risk to me.
16 The exposure draft also suggests that inquiry and
17 observation of a control may provide sufficient
18 evidence of whether a control is effective even
19 without documentation. If fraud is going on, top
20 management is not going to tell you that during an
21 inquiry. The very fact of observing behavior changes
22 that behavior.

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1 Finally, in my opinion, the standard seems
2 to suggest -- although I will recognize it is not
3 explicitly stated -- that smaller entities can get by
4 with relatively unsophisticated financial reporting
5 staff. But even if a business enters into simple
6 transactions -- no derivatives, no leases, no defined
7 benefit pension, post-retirement benefit plans --
8 they still will have deferred transactions, and
9 they'll still have to prepare a statement of cash
10 flows.
11 FAS 109, 1048, FAS 945, not to mention any
12 applicable EITFs and staff positions are complex
13 standards requiring high level skills.
14 MS. VIRAG: Jeff, did you want to comment
15 more than your yes?
16 MR. STEINHOFF: No.
17 (Laughter.)
18 MS. VIRAG: Gaylen Hansen.
19 MR. HANSEN: As I read the standard, it
20 appears to me that scaling applies to all companies.
21 I think the standard says it does. It is not just
22 small companies. I'm not sure it really articulates

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1 how that works, other than it is based on risk which
2 I think that should be the approach.
3 Then just to speak to what was said by
4 Jeff, I mean, I agree with the idea that you have to
5 have competent people internally. But let's face it,
6 in a small business, in the small companies, it is
7 really 95 percent people and 5 percent systems and
8 not the other way around like in the bigger entities.
9 I mean, I do know that there are specific
10 technical issues that have to be handled by those
11 competent individuals, you have to have internally.
12 But it is not as pervasive in the larger companies.
13 So I think the idea of scaling is what is
14 going to make this work for the smaller businesses.
15 Some of them don't have deferred taxes. I
16 know my clients don't because they don't make any
17 money. They're losing money. I wish they had
18 deferred taxes. 109 is particularly difficult for
19 them.
20 MS. VIRAG: Richard Dietrich?
21 MR. DIETRICH: Two questions about this.
22 One, I am unsure about the word "size" in there. Bob

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1 Kueppers mentioned it earlier in his comments. It
2 seems to me that that's making somehow implicitly an
3 argument about cost-benefit analysis of the internal
4 control testing relative to the size of the company.
5 Alternatively, the term complexity that's
6 used is really talking about the need for evaluation
7 and judgment. And I think of those things as very
8 different. It is quite probable they are correlated.
9 Smaller companies may be less complex. But I think
10 those two things, at least in my mind, are muddled.
11 The other thing Gaylen Hansen mentioned
12 earlier was this two-person entity. And so I asked
13 myself what if one of the two people quit. And then
14 we had a one-person entity.
15 Do we really have to say that we expect
16 every entity to have effective internal controls?
17 What if it is a one-person entity?
18 MS. VIRAG: Damon Silvers?
19 MR. SILVERS: When the question comes up,
20 do we really expect every entity to have effective
21 internal controls, that's like hitting a button.
22 Before I do my automatic playback on that

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1 subject, I want to say a word about just the way in
2 which the board approached this issue of
3 scaleability. As a conceptual matter, I think this
4 is exactly -- as a broad conceptual matter, exactly
5 the right way to do it. Not to say some companies
6 the auditor ought to have a scaled approach and
7 others they shouldn't, or anything like that.
8 And also not to fall into the trap of
9 saying that any particular financial metric is a
10 proxy for complexity. There are relatively large
11 companies that are relatively simple and relatively
12 small ones that are relatively complicated.
13 Financial service companies that are small may be
14 more complicated, and a biotech start-up might be
15 large on a market cap basis. So I think this is an
16 area -- my prior comment talked about getting the
17 foundations of the pillars right.
18 I think this is an area, together with the
19 notion of shying away from a design audit approach,
20 and a few other areas, where the board and the
21 commission have gotten this right.
22 Again, I think we need to be wary here

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1 that in the interstices and details, the standard
2 messages are being sent that somehow smaller or
3 simpler companies shouldn't be audited.
4 And that a perfunctory kind of -- that it
5 is okay for either the company's assessment, the
6 SEC's business, or the auditor's audit ought to be
7 kind of a pro forma exercise. It absolutely should
8 not. I think if the collective opinion of those who
9 know best is there are any words in this that point
10 in that direction, they ought to be changed.
11 Now for the auto-play part. Anybody who
12 wants to have access to the public's money, whether
13 it is a one-person company or a no-person company --
14 right -- should be able to say they have adequate
15 internal controls. I do not believe that anyone
16 should be allowed to call up one of our union members
17 on the phone at home and offer them a security for a
18 company which does not have adequate internal
19 controls. I do not believe anyone can say they
20 should with a straight face.
21 Thank you.
22 MS. VIRAG: Leroy Dennis?

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1 MR. DENNIS: I want to comment a little
2 bit on some of the things Joe mentioned. I agree
3 with him. I'm concerned about the messages. I
4 support the standard and where it is going. When I
5 look at smaller companies, complexity is going to
6 drive what the words are going to do, not necessarily
7 the size. A company that invests in its controls,
8 whether it is a small company or a large company, is
9 probably going to have a more efficient process
10 performed by the auditors.
11 But if I look at a smaller company that
12 has -- where you are relying on management to make
13 sure controls are implemented properly, and to your
14 point of how do you test management, you've got to
15 rely on the audit committee. The audit committee has
16 to be more effective probably in that environment
17 than in an environment where you have much more
18 robust transactional controls.
19 If you have a situation where you don't
20 have that oversight of the management by an effective
21 audit committee, I think you're going to have
22 proportionally more harm done than a company that

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1 does have those controls. I think the messages have
2 to be that this is really in the company's control as
3 to how much they want to invest in their systems.
4 And if they invest the proper amount, as
5 their shareholders would want, then they could have a
6 more effective process. If they decide to invest a
7 minimal amount, I would guess proportionally their
8 audit fees and the opinion to get to the control is
9 going to go up.
10 MS. VIRAG: We are going to go to break.
11 When we come back, I will start with Ted and Lynn.
12 Everyone can give thought to the question.
13 MR. RAY: Before you get up from your
14 seats, one thing I neglected to mention in my opening
15 remarks this morning is that we do have time set
16 aside beginning at 5:00 o'clock for emerging issues,
17 if there are any. I have not received any
18 suggestions for any issues that we ought to discuss
19 in that session to date, but if you have any you
20 would like to discuss, please see me during one of
21 the breaks and we can see if we can get that teed up.
22 With that, we do have a half an hour

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1 break. We'll see you back here at 11:00 o'clock.
2 Thank you.
3 (Recess.)
4 MR. RAY: If everyone would please take
5 your seats, we would like to resume the meeting.
6 I declare the break officially over and
7 turn the floor back over to Sharon.
8 MS. VIRAG: I think we will start with Ted
9 White.
10 MR. TED WHITE: I had a quick statement on
11 the question. First, I agree with the statement. I
12 agree with the approach. My single comment here is
13 that I would urge the board and the staff to
14 resist -- even strongly resist -- any approaches that
15 would, under the guise of scaling an audit, come up
16 with a two tiered process or anything that has lower
17 standards just because a company is small.
18 I believe what Damon said is that size and
19 complexity are two separate issues, and you can't
20 assume because a smaller company is small, it is less
21 complex and vice versa. Both of those concepts
22 should be included in this standard, remain in it.

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

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

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

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

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1 PP&E additions and intercompany accounts as low risk.
2 And yet those were the items that were actually
3 manipulated at both Health South and WorldCom and
4 we've heard discussions about accrued payroll and
5 accrual for vacation allowance were two of the
6 accounts manipulated at Qwest to turn around and make
7 the numbers.
8 So one of the complexities that the
9 standard really doesn't adequately address or get
10 into is how is it that you translate -- how is it
11 that you go about making that risk assessment and
12 make sure that you don't make the same mistakes that
13 others have made, that those type of things are
14 automatically low risk. And I don't have to spend
15 much time on them when, in fact, some of those
16 accounts have turned out to be very, very
17 problematic.
18 And I think there's very little --
19 actually, there's probably no discussion in the
20 document, if you will, about the fact that you may
21 have items that you typically would assess at low
22 risk and most people would assess at low risk. And

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1 yet in reality, they turned out to be extremely high
2 risk and been evident in multi-billion dollar
3 misstatements that have cost investors tens
4 of billions of dollars.
5 And somehow this document needs to come to
6 grips with that issue and talk about the fact that,
7 you know, just because you or I may think it is low
8 risk doesn't necessarily mean it is. You need to be
9 thinking about that and that's where in the O'Malley
10 panel report, they did a nice job of saying that's
11 where the auditor that's thinking about putting on
12 that skeptical hat, and is that type of situation
13 potentially existing here. You don't have that here,
14 which, quite frankly, takes us back to repeating
15 history again.
16 MR. OMTVEDT: I apologize for speaking out
17 of turn here. But, Lynn, back to your point, I agree
18 with your point. But the issue here isn't the
19 absence of control, it is more a case of management
20 override. And once you have management override or
21 you have collusion to circumvent a control, then you
22 killed the effectiveness of the controls that were

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1 there in the first place. And that's back to my
2 point about we need better fraud detection
3 methodologies in the audit process.
4 MR. TURNER: I think in a lot of cases
5 that's true, Craig. But in the WorldCom case when
6 you started to look at the intercompany accounts --
7 and Cynthia probably knows this better than me -- you
8 didn't have intercompany accounts capturing the data
9 in the way controls need to capture the data.
10 That was just not override. That was the
11 type of systems and the information in a company that
12 you didn't have especially in light of all the
13 roll-ups and consolidation that occurred.
14 MS. VIRAG: Damon Silvers has his sign up.
15 We'll move to him.
16 MR. SILVERS: Many years ago, I had the
17 experience of sitting in a small room at the
18 Securities and Exchange Commission without any
19 windows.
20 (Laughter.)
21 NEW SPEAKER: That was special for you,
22 Damon. There are only two of them, but they have

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1 very bright lights.
2 MR. SILVERS: That's right. I was sitting
3 on John's side of the table, so to speak, in that
4 room. Hopefully, John will stop me if I say anything
5 I'm not supposed to. It was a long time ago.
6 And there was an individual on the other
7 side of the table --
8 MR. TROTT: Stop.
9 MR. SILVERS: There was an individual on
10 the other side of the table who neglected to ensure
11 that his firm had counted the inventory in the
12 warehouse. And that individual was crying. Turned
13 out -- I think it wasn't his responsibility to see to
14 it. But that failure to do so allowed other people
15 to misrepresent what was in that warehouse, and there
16 were serious consequences to the investors in that
17 modestly sized public company.
18 That's why we need to have a standard here
19 that will basically direct both companies and
20 auditors to do their very, very best to figure out
21 what's important and what isn't, and not presume that
22 it isn't important if it turns out that it might well

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1 be.
2 Nobody wants to be in that room on that
3 side of the table having that discussion, certainly
4 not the investors who lost the money.
5 Now, the -- this is another one of these
6 things -- there's a lot of people who paid a lot of
7 money to get other people to assert nice finely
8 published bound volumes that somehow the work of this
9 board is imperiling the efforts -- the Congress of
10 the United States protecting the investing public in
11 the United States is somehow imperiling the national
12 interest because Chinese parastatals and central
13 Asian start-up companies feel leery about coming to
14 our markets to issue their stock.
15 While I certainly understand that if
16 you're someone like, say, Wilbur Ross, who has a
17 large investment in Chinese parastatals which he
18 would like to take public in our markets, you might
19 be able to buy an infinite number of academics to buy
20 that result.
21 I fail to see what anything like this has
22 to do with the national interest, particularly, I

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1 find it offensive the suggestion that retired steel
2 workers whom no one would lift a finger to protect
3 when their jobs were going overseas ought to put
4 their retirement assets at risk to subsidize the jobs
5 of investment bankers.
6 I think that's precisely what is being put
7 on the table here.
8 MS. VIRAG: Cynthia Cooper.
9 MS. COOPER: I want to follow up on what
10 Craig and Lynn said about WorldCom. If you look at
11 the WorldCom fraud, these entries were post-close
12 on-top entries. Management closed the books and
13 records at the end of the quarter. They said here is
14 where we are. Here is what we told the analysts we
15 were going to make this quarter. Then they booked
16 these huge on-top post-close entries.
17 In the case of the external audit, Arthur
18 Andersen did not have access to WorldCom's accounting
19 system. They relied on management to provide them
20 with the schedule they needed. They didn't go into
21 the system and query for these on-top entries. If
22 they had, the large entries would have fallen out.

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1 In the case of WorldCom, the other thing
2 that went wrong is the external auditors really
3 shared too much information in terms of their scope
4 with management, so they lost the element of
5 surprise.
6 What happened was when they told
7 management we're coming in to test construction in
8 progress and here's how we're going to test it, a lot
9 of these entries were sitting in CIT. Management
10 went in, moved the entries around in small dollar
11 increments that would be less likely that the
12 external auditors would detect it.
13 And the other thing that Andersen did was
14 they relied heavily on analytical review. So they
15 would come in each quarter and look at line costs as
16 a percent of revenue and compare that with prior
17 quarters and everybody was in line. It was flat at
18 42 percent. Andersen looked at it and said there are
19 no anomalies, everybody looks good. They didn't
20 compare it to a peer company like AT&T and others
21 which I think is an excellent suggestion Craig
22 mentioned. They did little substantive testing

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1 because they relied on the strength of internal
2 controls.
3 For example, in the area of property, they
4 only had six capital additions in the first half of
5 the year and none in the second half of the year
6 based, in my view, on over-reliance on internal
7 controls.
8 So if any of you guys have questions you
9 want to ask me, I'd be happy to answer them.
10 MR. RAY: I think this discussion about
11 fraud is very enlightening. You will have a chance
12 to talk about fraud this afternoon at our session.
13 Maybe if we can -- I think we need to try to focus on
14 these questions that we have teed up. I think this
15 is a very important one to make sure we are heading
16 in the right direction on the scale. If we could try
17 to focus on this, that would be very helpful.
18 Thanks.
19 MS. VIRAG: Ed Trott.
20 MR. TROTT: Why do I need this section in
21 the document at all if I'm using a risk-based
22 approach? Wouldn't that cover all these thoughts?

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

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

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

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

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1 number of comments and I believe that's where the
2 staff thought that some of these things needed to be
3 addressed to answer where there was more work going
4 on than needed to be done. Not to let there be less
5 work, but to allow the people hung up on specific
6 words to see their comments and to incorporate
7 guidance that I felt was sufficient on its own into
8 this standard being separate, which I also thought
9 was sufficient.
10 That being said, we are at the point where
11 we have something on -- out there, and I think it is
12 there. It is trying to be clarifying. I do believe
13 overall it might have been an overstep to give a new
14 number to the standard. It is implying it is so much
15 more drastically different, and I do believe it was
16 to incorporate some of these subtleties that I
17 believe were already in the document.
18 Relative to that, I think relative to
19 size, the question that is up here, we already had
20 the flexibility in there. I agree with John. But if
21 that unintended consequence that people see the
22 tiered approach, because I think in some cases

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1 smaller companies, you may have to do additional work
2 in areas that you wouldn't have done because they
3 were done a little differently.
4 So we are where we are. I think we have
5 listened to folks. There was the cry for some
6 clarification. The staff has answered that cry. We
7 need to clean up any unintended consequences from
8 that, but move forward without, you know, a major
9 revamp of the activities.
10 I think that's actually what you presented
11 to us, though it has been labeled in a much grander
12 scale.
13 MS. VIRAG: We have about five, maybe 10
14 minutes left on this subject. I'm going to try to
15 get everyone whose tent card is up. Joe Carcello?
16 MR. CARCELLO: I think in general, the
17 standard is pretty well written. The one thing I
18 would suggest for you to think about, though, is on
19 paragraph 9, the note, footnote number 6, where you
20 make specific reference to size cutoffs.
21 On the SEC advisory committee, on smaller
22 public companies, I'm afraid that could be misused by

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1 people. I'm afraid people could look at that and
2 say, well, you're below a certain size cutoff without
3 really thinking through rigorously the issues of
4 complexity. And it is very likely a company could be
5 below those size cut-offs and be complex and really
6 should have an audit scale up and vice versa.
7 And although the standard certainly talks
8 about that, by putting in specific dollar amounts
9 with the imprimatur of an SEC group, although this
10 was privately funded, I think runs the risk of being
11 potentially misused.
12 MS. VIRAG: Lynn Turner?
13 MR. TURNER: I agree with Ed's question
14 and Arnie's answer. I think if you're really serious
15 about a principle-based type of approach -- which I
16 agree with -- I think you start taking yourself very
17 much so into a rule-based approach when you start
18 defining here's the size of companies, putting in
19 numbers. There's no way at that point it isn't
20 principle-based, it is rule-based, and you start to
21 lose it.
22 I would suggest that a better way to deal

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1 with that would be right up front, lay out in bullet
2 point, what your key principles or objectives that
3 you are trying to get to which aren't there and I
4 think should be in any principle-based standard.
5 Tell the auditors, these people around the
6 table, what it is you expect them to achieve. You
7 expect them, first bullet would be, to use risk-based
8 approach that focuses on material items that are, in
9 fact, considered to be the more risky.
10 Bullet 2, expect them to get enough
11 knowledge about the business such that they can make
12 decisions in light of industry and peer groups. They
13 have to gain knowledge of the controls that are there
14 and put in place.
15 The third bullet would be based on that,
16 you expect them to scope the testing and perform
17 enough testing so they get evidence from wherever,
18 their own testing, or use others, but they've got to
19 get sufficient testing to provide basis for telling
20 the public whether those -- you know, those controls
21 exist and are working with reasonable assurance.
22 The fourth bullet on reporting.

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1 Come back and tell -- here is the
2 objective we expect you to achieve in reporting.
3 This is another area where this is very much
4 rule-based. You give the auditors one reason why is
5 particular type report, you don't give them
6 flexibility. You talk about giving them judgment,
7 latitude to tell the public something about controls
8 if they think there's something that needs to be.
9 Put those objectives right up front and
10 lay those out. It gives you more flexibility in the
11 later part of the document to have more room for
12 judgment. They know what they have to come back and
13 achieve. It increases your ability to use judgment
14 but tells everybody what they have to get to and what
15 they will be held accountable to at the end of the
16 day.
17 When you get there, you don't need this
18 two tiered standard which you have in this case, one
19 for small, one for large.
20 I certainly encourage you to go down that
21 path.
22 MS. VIRAG: Gaylen Hansen.

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1 MR. HANSEN: As I said earlier, as Arnie
2 pointed out, I think maybe changing that title to
3 make sure that people don't get misled, that the
4 scaling related solely to small companies would be
5 something to -- footnote 6, I don't understand what
6 that did anyway. It is sitting there. Sort of gives
7 you an idea of sizing. But how it translates to the
8 standard, I'm not quite sure.
9 The only other point I had to make on this
10 particular issue was I think the same thing could be
11 said of the multi-location testing. At the point --
12 back on -- in AS-2, when the standard sort of said
13 that you had to cover a larger portion, and then
14 that's taken back, that's in the same boat with what
15 Ed's talking about.
16 This is risk-based. You're going to make
17 those decisions on all locations. Under that sort of
18 principle-based approach, that wouldn't be any
19 different than any other scaling decision.
20 MS. VIRAG: Bob Kueppers?
21 MR. KUEPPERS: I wanted to pick up on a
22 comment Kimberly made about not needing to renumber

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1 the standard. I don't think anybody has picked on Ed
2 yet. I think we should call this AS-2-R and I think
3 it should be just fine.
4 MR. TROTT: Which firm are you with?
5 MR. KUEPPERS: One substantive comment. I
6 hear the debate about the -- I don't believe this is
7 two standards in one cover. I really don't. The
8 question of whether or not you should call out or
9 have separate importance to the smaller company, I
10 think is one that is the result of all the
11 sensitivity and the politically charged environment
12 around this.
13 We know the SEC is determined not to
14 exempt. We have to find a way to make sure the
15 thousand companies that are not yet in the system
16 have an audit approach that is AS-5 compliant at the
17 end of the day.
18 The one thing this might provide, though,
19 is a portal to plug in additional guidance at the
20 small end of the spectrum. I'm not talking about
21 size. I'm talking about complexity. I think that's
22 the biggest driver. I think it might be helpful if

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1 all the audit firms that have not done one of these
2 audits yet because their clients are in the
3 non-accelerated filer category, additional guidance
4 for getting it right at the less complex company
5 level, this would be the place in the standard that
6 guidance would sort of plug in.
7 I think that small business audit guide,
8 even though in principle I'd love to have one thing
9 and have the whole continuum be scaling. I think we
10 need to provide extra help for a big part of the
11 population that is not in the system under 404.
12 MS. VIRAG: Damon Silvers?
13 MR. SILVERS: First, I want to echo what
14 Bob just said about the appropriateness of that kind
15 of guidance for the non-accelerated filers. I think
16 that most investors look at the non-accelerated
17 filers and say we want the same principles to apply
18 to everybody, but in real life, when people are doing
19 things, it looks different when you talk about a
20 company of 30 people than a company of 30,000 people.
21 That's just a different thing. There ought to be
22 some help to the firms and to the companies that

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1 are -- will be engaging in that. We believe it is
2 important they engage in it. That kind of help would
3 be a good thing.
4 The -- I also think the point -- I want to
5 support the point John Morrissey made about why this
6 section is in there. I think that it's -- while it
7 is correct, Ed's analysis is correct at one level.
8 Ed isn't generally correct at all.
9 But in this respect, there is a point to
10 this which is about the fact that many people of good
11 will in the preparer community have felt as though
12 they've operated in an environment under AS-2 in
13 which there's nobody listening to the realities of
14 their business and the relative complexity or lack of
15 complexity of their business.
16 I think it is important for the integrity
17 of the whole process that those concerns be taken
18 seriously and addressed. I think that's what this
19 section tries to do. I think with some degree of
20 success.
21 The issue that remains, in my opinion,
22 about this section is the potential for the

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1 misunderstanding that this section constitutes, as I
2 think Bob just said, two standards under one cover.
3 There's got to be absolutely no ambiguity
4 about that question. It is one standard. Right. It
5 provides -- allows the auditor of the mega company to
6 think about the relative complexity of the mega
7 company compared to other mega companies, but does
8 not give any special breaks to the auditor of the
9 small company in terms of the standard.
10 So I think to the extent that the title,
11 for example, leaves any ambiguity, that title needs
12 to be altered.
13 I also think with respect to the footnote
14 issue and the issue of throwing numbers any place,
15 there needs to be greater clarification that while
16 certainly numbers like market cap and total revenue
17 are relevant to the question of complexity, they're
18 not determinative.
19 MR. COLMAN: I just want to support what
20 was said by Bob and Damon, to be able to say there's
21 a standard and a standard and scale it all the way
22 down. That said, there's unique characteristics,

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1 having guidance -- I know it is here -- whether
2 there's other guidance being worked on, I think could
3 be helpful.
4 Specifically, though, I think we had a
5 lengthy conversation about the risks of company level
6 controls, and the degree of directness or
7 indirectness, the risk of how much that would either
8 drive no testing or the nature, time, and extent of
9 the type of testing of process level controls.
10 I would ask that you take that
11 conversation and marry it to what is in paragraph 12
12 about whether or not we are helping or hurting in
13 some of that.
14 MS. VIRAG: The next subject is a
15 discussion of the differences between management's
16 evaluation process as management would follow it
17 based on the SEC's proposed guidance and the process
18 the auditor would follow under the board's proposed
19 standard. The question is would management's process
20 for evaluating its internal control under the SEC's
21 proposed guidance and the process the auditor would
22 follow under the board's proposed standard raise

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1 implementation difficulties for the auditors or
2 management? If so, how can these difficulties be
3 addressed or managed?
4 Howard Johnson?
5 MR. JOHNSON: Silence is golden on this.
6 I haven't spoken to anything yet and I thought this
7 might be a good one since there's a break in the
8 action here. The interesting thing to me on this SEC
9 is now for management to allow other forms besides
10 testing of controls, following things like monitoring
11 just daily interaction.
12 First of all, there's a lot of value to
13 that. I think we hit on it this morning. Craig
14 mentioned more than once that we have to get the
15 auditors out of the box and do other things besides
16 just appear to be too far down in the details.
17 And there's a lot of stuff you can do for
18 monitoring of the control environment. You still
19 need to take a look at it once in a while to make
20 sure there isn't something that's changed
21 significantly and also do things like analysis to see
22 what's going on outside the bell-shaped curve, really

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1 weird stuff. Either too good to believe or just off.
2 Some of that stuff you get through doing
3 things like monitoring. Not just testing.
4 So I kind of have to say I like the SEC's
5 extra verbiage and allowance. I think from being
6 down in the details, seeing what's happened both on
7 management's side and public accounting's side, when
8 I was with Lowe's, it is a big sigh of relief to have
9 other options than doing testing to make sure the
10 control environment is really what it appears to be.
11 MS. VIRAG: Kimberly Gavaletz?
12 MS. GAVALETZ: I would agree with Howard's
13 comments relative to a broader spectrum of evidence
14 that supports -- that management has a control
15 environment. The one concern I still will echo to
16 the group is keeping the ever increasing potential
17 for divergence between what the SEC guidance is and
18 what the PCAOB's.
19 This reconciliation going forward is
20 something we're going to have to be very vigilant
21 about. I applaud the SEC for keeping it sufficiently
22 almost principles-based. I know there's a clamor for

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1 more detail from others. I would hesitate in telling
2 people exactly how to do the things. I think you
3 tried to do that. I hope we don't keep doing that.
4 I think that gives more potential for things to
5 diverge.
6 I would just lay out as an indirect answer
7 to this, as we stand right now, there are kind of the
8 right levels, but I see that it exists out there,
9 there's the potential long term and we're going to
10 get very -- to not let that occur and keep the
11 reconciliation and test ourselves before either is
12 released on making sure those are clear, so we don't
13 confuse the management side of the things that are
14 trying to implement. And then the external auditors
15 who are trying to assess management and then getting
16 things out of sync. We do have the potential for
17 that.
18 MS. VIRAG: Randy Fletchall?
19 MR. FLETCHALL: There clearly are
20 differences between the PCAOB's proposed standard and
21 SEC's proposed guidance. But let's face it.
22 Management is in a different place than auditors.

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1 They are there every day. They are running the
2 company. It makes sense. One of the criticisms
3 before was auditors were driving management to do
4 things because there was only AS-2.
5 To the extent there are differences,
6 that's probably good. A concern would be if there
7 are so many differences that people can't communicate
8 and we have gaps or duplication because as we manage
9 these total costs down, I can go back to, Charles,
10 what you said earlier, about your role as an audit
11 committee member.
12 We think it is terribly, terribly
13 important to make sure there is a thoughtful
14 collaboration between management teams who we might
15 have turned into auditors, let them manage, but take
16 on the responsibility they have under 404 and
17 certifications as Bob said to do what they do well.
18 There is optionality, flexibility. All the effort
19 might be reduced in some way, so what a management
20 team chooses to do will have an effect on what an
21 auditor does. What we are preaching to our people is
22 a thoughtful collaboration, sharing of details,

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1 collectively management does its job, auditors do
2 their job, and collectively it is done in the most
3 efficient manner.
4 MS. VIRAG: Vin Colman?
5 MR. COLMAN: Just adding to that, we are
6 doing the same thing. I think there should be
7 differences. That's a good thing. I think it will
8 affect the process for which there's been so much
9 criticism, meaning to make sure you understand what
10 has management done in their process before you start
11 even the assessment that's in AS-5. Understand what
12 they have done. How they support their assertion.
13 And it could assist in many aspects of
14 AS-5 whether the nature, time, and extent of what
15 you're going to do, your risk assessment, the use of
16 work. Others, time -- there's a lot of areas that
17 will affect.
18 We're going to educate our people to try
19 to understand what management is doing first and
20 engage in that rather than run first, decide what
21 you're going to do, and figure out how you can
22 reconcile back to management. That would be a bad

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1 process. I think everybody agrees with that. Some
2 of this is like we talked about this morning around
3 the implementation.
4 That said, there are a couple of areas
5 where I do think it would be helpful to have just
6 from an efficiency standpoint, whereby when the
7 auditor comes in, they're speaking from the same song
8 card. One was -- we touched upon before, the
9 discussions around the entity level of control, the
10 degree of precision in the PCAOB standard and the
11 documentation that is in the SEC standards. Elements
12 in both of them are very good. I think coming
13 together would really help the process ultimately
14 from both an effectiveness and an efficiency kind of
15 standpoint.
16 Second, around the strong indicators of a
17 material weakness. There's breakages between the
18 two. I think some people could think there are
19 subtle messages being sent through there. I'm not
20 sure there are. I think it needs to be -- have
21 collaboration about -- so that the management's
22 trying to decide what are material weaknesses and

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1 what an auditor is trying to decide. Quite frankly,
2 they should be aligned.
3 MS. VIRAG: Leroy Dennis?
4 MR. DENNIS: I want to expand a little bit
5 on what Vin said and what Lynn said earlier. Lynn
6 talked about putting principles in the introductory
7 part of AS-5.
8 I think having the same type of
9 understanding of the SEC guidance would help to make
10 sure the two standards are aligned at least in
11 principle and would serve to eliminate any confusion
12 that they are not.
13 MS. VIRAG: Bob Tarola.
14 MR. TAROLA: Thank you.
15 This one worries me.
16 I was glad to hear from Randy, Vin, and
17 others words like collaboration, engagement, and sort
18 of working together to identify the important risks
19 and the way risks are mitigated. I think that's a
20 healthy exchange that I don't think has existed to
21 the degree necessary in the past, and I think this
22 will drive that.

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1 I further believe that the discussion of
2 important risks should be held with the audit
3 committee to make sure the management team and the
4 outside auditor are in line -- or in alignment as to
5 all of the important risks. And, in fact, how
6 they're going to be -- how they are mitigated and how
7 we will each do our job in making sure that we can
8 provide a certification we have to provide.
9 The -- heretofore, there has been very
10 little collaboration. It has been pretty much a
11 gotcha situation. My hope is we can somehow avoid
12 that and management teams and auditors could
13 basically work together to protect investors by
14 agreeing on important areas to review and
15 complementing each other in some way toward achieving
16 satisfaction that risks are appropriately mitigated.
17 MS. VIRAG: Jeff Steinhoff?
18 MR. STEINHOFF: I think it would be normal
19 to have some differences in the way this is stated to
20 the respective parties. Management has a much
21 different responsibility than the auditor has. And
22 it's important that management realize that it is the

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1 one responsible for ensuring there be adequate
2 controls. It is a fundamental management role.
3 It is not a process management should be
4 going through to comply with what an auditor wants.
5 It is good business practice. It helps protect the
6 business as well as the shareholder. But it is a
7 fundamental management responsibility.
8 So if that is always placed in mind, then
9 the auditor's role is to provide a check over whether
10 management is reasonably carrying out its
11 responsibility and it shouldn't be the auditor
12 driving management. And both parties should be
13 really having a constant dialogue as to those things.
14 We have faced some of that at the federal
15 government, where management just solely wants to
16 find out what does the auditor think. So if the
17 inspector general or GAO has issued a report,
18 management will jump right on and report that as a
19 weakness. They feel in some quarters as long as they
20 have done that, they are compliant with the laws.
21 That is very far from the truth.
22 They have a responsibility to assure on an

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1 ongoing basis that things are working well, and I
2 think that it's all right for the language not to be
3 exactly the same in every paragraph. And as long as
4 there's a clear understanding, I think this can work
5 well.
6 MS. VIRAG: Any other comments before we
7 move on?
8 I think we're going to break for lunch at
9 this point a few minutes early. If everybody could
10 meet back here at 1:20 that would be great.
11 (Whereupon, at 11:51 a.m., the meeting was
12 recessed, to reconvene at 1:20 p.m., this same day.)
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1 AFTERNOON SESSION
2 (1:20 p.m.)
3 MR. RAY: I would like to restart the
4 meeting since most people are sitting down. If the
5 remaining few could please take your seats, I will
6 turn this back over to Sharon Virag to continue our
7 discussion on internal control.
8 MS. VIRAG: The next topic for discussion
9 is using the work of others. We have two questions.
10 You can take them in any order you like.
11 First, does the proposed standard meet the
12 objective of removing unnecessary barriers to using
13 the work of others?
14 Does the proposed standard promote better
15 integration of the audits?
16 Joe Carcello to start us off.
17 MR. CARCELLO: Since no one else wants to
18 talk, I'll take the microphone.
19 Again, I think what you have here is
20 reasonable in many ways. I guess the one concern I
21 had is in AS-2, at least my read of AS-2, there was a
22 clear demarcation in my mind between relying on the

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1 work of management and relying on the work of
2 internal audit, particularly internal audit that
3 follows the standards for the professional practice
4 of internal auditing.
5 I thought that was a good demarcation.
6 That seems to have gone away in AS-5.
7 In the discussion paper you gave us to
8 prepare for today, you have a statement in there
9 essentially focusing on competence and objectivity,
10 which I agree is the focus. It is not on the job
11 title. I agree clearly that is by far the least
12 important. I don't know if I completely would ignore
13 it. In my mind, job titles do matter somewhat
14 because they create a mindset.
15 I think there is a fundamental difference
16 in mindset between internal audits and management
17 because they may involve compliance with a set of
18 professional standards. When you rely on the work of
19 internal audit, there's in many cases a set of
20 professional standards, a certification, a code of
21 ethics, a code of responsibility that those people in
22 many cases have internalized and they're also bound

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1 to observe.
2 That's not necessarily the case when you
3 rely on management. So I think kind of equating them
4 is potentially dangerous.
5 I think the language that you had in AS-2
6 was in many ways better than what you have here.
7 MS. VIRAG: John Morrissey?
8 MR. MORRISSEY: I would like to -- first
9 of all, I agree with everything Joe just said.
10 I think looking back on my days as an
11 internal auditor, the internal audit function can be
12 very, very valuable to an organization. As you
13 mentioned, they have their own ethics requirements,
14 professional standards; and in a properly structured,
15 organized audit function where they report directly
16 to the audit committee, they are in many ways
17 accountable to the audit committee and investors
18 directly.
19 I think this is something that really
20 deserves serious attention and recognition that it's
21 worth investing in an internal audit function from a
22 public policy standpoint. And to elevate them --

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1 because they are different from management, they
2 should be treated differently from management.
3 I think the opportunity within the
4 standard to call them out and give them expert
5 recognition when properly structured, when properly
6 trained, when properly organized, provides an
7 opportunity for management to invest in good internal
8 controls at the most important level, and that's at
9 the people level. I think if you look at this, you
10 can't come out strong enough in order to encourage
11 that, at least in my view.
12 MS. VIRAG: Gaylen Hansen.
13 MR. HANSEN: When it talks about whether
14 the auditor accepts the testing of another
15 individual, it needs -- I would hope that it would be
16 a little bit more specific. It says some testing is
17 required. Some testing seems a little vague to me in
18 terms of the extent. I don't know if you want to get
19 that cookbook-ish about it, but I think something
20 more than "some" would be a good direction.
21 MS. VIRAG: Kimberly Gavaletz?
22 MS. GAVALETZ: One comment on the section

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1 that really started to deal with this, in removing
2 the barriers to using the work of others where you
3 address the principal evidence.
4 I just wanted to comment that I agree with
5 eliminating the principal word and evidence because
6 it is the right level of evidence you need for
7 whatever is there. I think principal evidence, that
8 goes along with everything was causing some
9 behaviors, that meant you couldn't rely on the work
10 of others to the extent if they had what they
11 considered the principal evidence, you had to redo
12 that particular work.
13 The importance is understanding the
14 fidelity of the evidence, understanding the quality
15 and qualifications of the person making that and the
16 objectivity of the partner making those judgments.
17 I think you did help clarify some and
18 remove barriers with how you addressed that
19 particular area under principal evidence.
20 MS. VIRAG: Joe Carcello?
21 MR. CARCELLO: Let me respond and follow
22 up on what Kimberly just said.

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1 I'm a little concerned with the principal
2 evidence provision being eliminated. It's not
3 necessarily that I think that the wording in AS-2 was
4 necessarily right. Again, I always kind of go to the
5 end point and worry about the potential consequences.
6 I asked some people this yesterday; let me
7 pose this to the group. If management personnel
8 appear objective and competent, could they gather the
9 principal evidence, and not just for the audit of
10 internal control but for the financial statement
11 audit? That really worries me.
12 With the audit of internal control, if we
13 do not get that right, that doesn't automatically
14 mean there's a misstatement in the financial
15 statements. But if there's a problem with the
16 financial statements and we don't get it right,
17 there's no backstop, no safety net. It is a change
18 not just for ICFR but a change for the audit of the
19 financial statements.
20 Here we're saying we can rely on
21 management to essentially do the work to audit the
22 financial statements if they appear objective and

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1 competent. If so, if that's true, what do we need
2 the auditors for?
3 And roll back the clock to the late
4 Nineties. Don't you think most everyone would have
5 described Mr. Fastow and Mr. Sullivan as honest, as
6 competent, if we were sitting here in 1998?
7 MS. VIRAG: Sam Ranzilla?
8 MR. RANZILLA: I'm not prepared to answer
9 that question, Joe.
10 (Laughter.)
11 MR. RANZILLA: Hypothetical.
12 I'd like to address two things. One is
13 the concept of principal evidence and, secondly, the
14 proposed auditing standard on the use of the work of
15 others.
16 With respect to principal evidence, I
17 support the elimination of those words. My own
18 belief is the elimination of those words doesn't do
19 much, if anything; and if they were driving behavior
20 that wasn't appropriate, which I think at best is
21 anecdotal evidence, then I think that's fine.
22 There's been a notion of principal

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1 evidence in the auditing standards long before
2 Auditing Standard No. 2; and it will continue to be
3 one of the implicit standards in an auditor's ability
4 to sign an auditor's report that says in my
5 opinion -- not in the opinion of management, and not
6 in the opinion of the internal auditors -- but in my
7 opinion, these financial statements are blah, blah,
8 blah, or this internal control is up or down.
9 So while I support the notion of removing
10 the words "principal evidence," I don't think it's
11 changed the auditor's responsibility with respect to
12 its ultimate objective.
13 With respect to the use of the work of
14 others, I don't support the issuance of standard
15 number 6, if we're going down that path. I think
16 that the board has made the appropriate changes
17 through auditing standard number 5. If there were
18 impediments to the issues that might have been
19 leading to less than optimal use of others in an
20 internal control audit, I think those have been
21 amended; and that coupled with existing auditing
22 standard number 65, I think is, in my belief, exactly

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1 where we want to be with respect to the integrated
2 audit.
3 So I do not support the proposed standard.
4 MS. VIRAG: Lynn Turner?
5 MR. TURNER: Once again, I'd agree with
6 those last comments of Sam.
7 I think the current standard that we've
8 got up there is fine. If you decide to go to in the
9 direction that you're headed, then I think you got to
10 couple it with being transparent to investors. I
11 think you need to first off clarify in the standard
12 that takes any of the burden off the auditor to
13 ensure they gain sufficient evidence that they
14 themselves have enough that they can conclude, and
15 that we're not going to hear cop-outs later on about
16 "well, that was done by the internal auditors" or
17 anything like that.
18 So I think you need to make it very clear.
19 I would do that, once again, by going and laying the
20 principles out right up front, in bullet form, and
21 note that one the principles is you have to get
22 enough evidence from the testing to form your own

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1 conclusion. You know -- at the end of the day I
2 don't have a problem if people want to use internal
3 audit. And pursuant to what John said, it is -- to
4 the internal audit department, because we know we
5 have some that are very good and some that are really
6 lousy and some that are somewhere in between.
7 That's where I think the SAS 65 on use of
8 specialists, as it exists, is already very good. It
9 talks about those situations and how you have to deal
10 with it. I don't see this as being an improvement on
11 that. I don't know why you do it. That's why I
12 agree with Sam.
13 But then I would come back and say in the
14 report, if you're using someone else to do part of
15 your work for you, I would like to know that as an
16 investor. Just as we require the auditors to tell us
17 if they're relying on work of others on the audits of
18 the numbers in the balance sheet or income statement,
19 and we note that, I think they should note that here,
20 too, and give us a heads-up.
21 I can only think of one reason you
22 wouldn't be able to tell us and that's not a good

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1 reason to leave it out in the first place.
2 MS. VIRAG: Damon Silvers?
3 MR. SILVERS: I think there's a principle
4 here that the board ought to follow in relationship
5 to these issues, which is the principle of the
6 integrated audit. That the degree of reliance which
7 an auditor can place on the work of others in the
8 control audit ought to be conceptually the same
9 degree of reliance an auditor is allowed to place on
10 the work of others in the financial statement audit.
11 I don't know the terms of art that get you
12 there, but I think that's the principle that you
13 ought to be following.
14 I think that the creation of a separate
15 standard on the work of others would suggest
16 something else is going on; and so I don't believe
17 that that's an appropriate thing to do.
18 And I believe, by the way, that this is an
19 area where a great deal of danger lies. I would call
20 the board's attention to the words of the statute,
21 section 404 which -- an attestation as to the truth
22 of the assessment by the independent auditor.

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1 That points at what's really going on
2 which is the independent auditor is slapping their
3 stationery on management's assessment. At that
4 point, somebody is violating the statute.
5 And the -- more -- from law to real life,
6 right? -- the risks that everyone involved in
7 creating such a situation would bring upon themselves
8 would be very dramatic, in relationship to the day
9 when a large company would explode as the result of
10 such a thing.
11 I can guarantee you if that were to
12 happen, and if somebody cab walk into a courtroom
13 with a defense lawyer and point to the standard, and
14 state, "the standard allowed me to rely on the
15 preparer; I should be able to walk out of this
16 courtroom free of liability and not in handcuffs," I
17 can guarantee you the judge will say that standard is
18 inconsistent with the statute and whatever you say
19 those words mean, they don't mean that.
20 It would be far better to get the words
21 right in the first place.
22 MS. VIRAG: If there's no other thoughts

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1 on that -- Marty Singer?
2 MR. SINGER: I might have some confusion
3 about this point. When I read it, I was a little
4 confused. I'm a little confused by the discussion.
5 When we talk about the work of others, we
6 had a discussion, I think two meetings ago, about
7 whether there ought to be different standards for the
8 work of specialists who were internal versus
9 external. And it seemed that there was a potential
10 of having some unnecessary barrier to having work
11 done by, let's say, an internal tax specialist.
12 What I'm unclear on is, is there actually
13 an objection here to having an outside audit firm
14 rely on the work of others in the area of cycle
15 counts of inventory, tax, or other preparation?
16 And, indeed, isn't one of the goals of
17 Sarbanes-Oxley to impose a standard of excellence on
18 your internal finance capabilities, so that more of
19 this work is done internally?
20 It may be that there is liability in
21 having an outside auditor rely on some of that work.
22 On the other hand, it is a reasonable expectation

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1 that management develops its resources to accomplish
2 this work.
3 I am really confused. I know Mark
4 mentioned earlier he's reluctant to have people from
5 the PCAOB comment on this; but I would actually like
6 some helpful comments in this area about the degree
7 to which we're discussing this.
8 I mean when we audit, for example,
9 inventory, is there really a question about your
10 public company auditor being able to rely on the work
11 of others in cycle discounts? Or are we going to
12 drive that level of work up to an outside vendor?
13 So I have perhaps some misunderstanding of
14 this issue, and understanding the degree, but some of
15 this discussion seems a little bit contrived as a
16 real world problem, at least to me.
17 MR. RAY: Let me comment just very
18 narrowly. I think your example was a good one. The
19 cycle account example, as I read the standards
20 currently, my reading is if the cycle accounts are
21 done periodically throughout the year by internal
22 auditors, the independent auditor may look at that

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1 work and evaluate it and decide whether they're going
2 to use that work as it relates to the nature, time,
3 and extent of work they need to do with regard to the
4 existence of inventory.
5 I think if that work was done by somebody
6 else, it's unclear as to whether the auditor would be
7 able to use that work.
8 But I'd certainly welcome other views on
9 that point under the existing standards again.
10 MR. OMTVEDT: May I offer you a
11 perspective on that and stay with your cycle count
12 example? At the end of the day, as a starting point,
13 the cycle counting is part of our management controls
14 just to be comfortable that our inventory systems are
15 working.
16 I think one needs to differentiate between
17 what's happening in the normal course of day-to-day
18 activities versus perhaps a situation where we have
19 the internal audit group going in to an audit on a
20 management location to test the quality of the
21 controls.
22 I think you really have three tiers here.

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1 The day-to-day activity, the -- separate to John's
2 point earlier -- the independent assessment of those
3 controls by a qualified internal audit group, and
4 then whether or not the external auditors can place
5 reliance on the work of the auditors.
6 I hope that helps.
7 MS. VIRAG: Lynn Turner, I think you're
8 next.
9 MR. TURNER: The question that Martin
10 poses here, though, is an interesting question. If
11 you look at the companies that disclose material
12 weaknesses after their first implementation of S-OX
13 404, including the external auditor requirement,
14 about 95 percent of management certified that the
15 controls were effective, right up to the last interim
16 period before a control weakness was disclosed to the
17 investors.
18 And so the question becomes, since that's
19 almost the entire population, just 5 percent short,
20 would you under this standard be permitted to rely
21 upon that 95 percent of management that had it wrong
22 right up to the very last quarter? And why would any

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1 auditor in their right mind be using that work by the
2 management team, because presumably they were doing
3 some testing or whatever to get to the
4 certifications? And it absolutely fell miserably.
5 Why would you under any circumstance
6 permit the auditors to rely upon it? That's why it
7 comes back to what John so appropriately said, of it
8 needs to be focused on an appropriately constructed
9 and staffed internal audit team. And as Sam said, go
10 back to the requirements that already exist or, are
11 not always working, but seemed to have move us along
12 out of the current SAS.
13 MS. VIRAG: Jeff Steinhoff?
14 MR. STEINHOFF: Of course, I guess I see
15 this as part of the overall process one has for
16 assessing risk. So I think the auditor would find
17 out what management does on a day-to-day basis to
18 assure itself it's running its business in the proper
19 manner, as I mentioned prior to lunch, I view the
20 internal control as management's responsibility, as
21 to management's advantage that it does this well.
22 Not to be compliant per se with

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1 Sarbanes-Oxley, but to run its business in an
2 efficient, effective manner.
3 In looking at the proposed standard, it
4 doesn't appear to me like the PCAOB is saying that
5 the auditor doesn't have any responsibility here;
6 they just take somebody else's work. I'm reading to
7 it say that the auditor is, in fact, responsible no
8 matter who does the work; and they don't share this
9 responsibility.
10 And if you look at -- I forget the section
11 it is -- section 9, the auditor must obtain
12 sufficient, competent evidence.
13 If you go to 10-B, the auditor must
14 evaluate the competence and objectivity of the
15 individuals. It lays out risk factors considering
16 the use of this other work.
17 If you go to paragraph 15, it appears
18 really to be saying that largely we expect you, if
19 you're using work, to be using the internal auditor's
20 work.
21 So I guess I viewed this as a reasonable
22 way to approach this and provide a framework to the

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1 auditor to consider a range of other work that may or
2 may not be done. If the auditor went in and found
3 that management did not have an internal audit
4 function, management was not reviewing its own
5 controls, or doing its cycle accounts, the auditor
6 would consider the control environment not to be very
7 good.
8 If the auditor found they were doing this,
9 they would certainly factor that into what testing
10 they may be doing. They may elect to observe a cycle
11 account or two; but I don't see in the standard that
12 it's really even implying that the auditor could just
13 simply say -- you know -- Marty's having these cycle
14 accounts, therefore I can rely on that.
15 I think the standard says I have to have
16 competent evidence at the end, and I can go about
17 having competent evidence in a variety of ways; and
18 it's not saying I have to go count every cycle or
19 inventory every item. But I have to use my
20 professional judgment in considering risk in making
21 that determination.
22 So that's -- I think this is really a

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1 reasonable approach to doing it; but it does not take
2 the responsibility off the auditors or shareholders
3 at all. At the end of the day.
4 MS. VIRAG: Marty Singer?
5 MR. SINGER: I agree with those last
6 comments. I do want to comment on Lynn's statistics.
7 We had this discussion before. It is not surprising
8 after the implementation of Sarbanes-Oxley and 404,
9 there were disagreements between management and
10 outside auditors on what was acceptable. The game
11 changed. There were new definitions of process. So
12 these statistics are somewhat artifactual.
13 The other issue is, of course, a lot of
14 these discrepancies revolved around the process
15 associated with smaller companies, an issue this
16 group is less and less sympathetic to, as you want to
17 get rid of any sort of departure from one size fits
18 all.
19 But the issue, of course, for smaller
20 companies was the issue of materiality, another issue
21 we discussed. I was talking to Vince earlier, and he
22 mentioned this as an important issue. You have small

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1 companies with GAAP earnings near zero and, for
2 example, in our case, we had a $50 million antenna
3 business, $2 million inventory. $50,000 of
4 discrepancy was a material weakness, because it
5 wasn't mentioned against the asset that was important
6 to shareholders, it was measured against GAAP. Okay?
7 If we are losing a whole lot of money it would have
8 been immaterial.
9 That was one of the delights of this whole
10 process. There were definitions of material
11 deficiencies or weaknesses that I think were somewhat
12 artifactual; but again, I agree with these last
13 comments. It doesn't suggest at all that the auditor
14 abdicates responsibility. What it suggests is that
15 you have learned competence on the part of management
16 in these areas, not learned dependence.
17 And management has to be for improving its
18 processes. Here it is like cycle counting and other
19 audit practices.
20 MS. VIRAG: Vin Colman?
21 MR. COLMAN: You know, I just thought it
22 has been mentioned a couple of times in the confusion

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1 about perhaps the paragraph on -- paragraph 9 which
2 is sufficient competent evidential matter. Marty,
3 your point, Sam raised, if standard number 6 is going
4 to stay, to bring these concepts -- and Lynn brought
5 this up -- I just thought it might be helpful to know
6 what it says. It might help this conversation a
7 little bit.
8 It basically says for assertions related
9 to material financial statement, where a risk of
10 material misstatement or degree of sub-activity
11 involved in the evaluation of audit evidence is high,
12 the auditor should perform sufficient procedures to
13 fulfill the responsibilities described in earlier
14 issuer opinion. In determining these procedures the
15 auditor gives consideration to results of work,
16 either test of controls or substantive tests
17 performed by internal auditors, and those particular
18 assertions, however, for such assertions, the
19 conversion of internal work cannot alone reduce audit
20 risk to an acceptable level to eliminate the
21 necessity to perform tests of those assertions by the
22 auditor.

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1 I think this is right on point to what is
2 missing -- performance -- in AS-6 to clarify it. It
3 is very subtle in paragraph 9, where you need to
4 obviously have sufficient evidential matter to issue
5 your opinion. This perhaps would clarify.
6 I think this is the point at when people
7 are simply saying could you go back to what was in
8 the old standards, I think that's what they mean by
9 it. It would be a really helpful clarification.
10 MS. VIRAG: Damon Silvers?
11 MR. SILVERS: I think the issue facing the
12 board is the question, not of whether or not we want
13 to build internal competence within issuers; I think
14 we all do. Marty's question is yes, we want
15 competence here and want technical strength. But the
16 dilemma that faces the board what is to do about
17 essentially the fact that no matter how good you are
18 as an internal auditor, you are not the independent
19 auditor.
20 And how to guide the independent auditor
21 in such a way that they can both make use of
22 information that's generated from internal expertise

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1 without confusing this question as to who is
2 independent and where the ultimate responsibility
3 lies.
4 And that's a challenging task. It is why
5 in my earlier comment, I said you need to keep your
6 eye on the notion that there's a kind of -- there
7 needs to be an integrated audit standard here, guided
8 by the audit profession's sort of historical sense of
9 how to do this in areas other than internal controls.
10 I think that's the right way to think about it. I
11 don't know what the words are that you need to write
12 to implement that.
13 On the other hand, I think we need to be
14 cautious about sort of assuming, for example, that
15 all kinds of terrible things are happening around
16 this -- different. For example, if you're dealing
17 with companies that are not profitable, losing a lot
18 of money, then you can easily measure materiality in
19 that circumstance.
20 But my understanding is if it is a
21 break-even kind of situation, that the materiality
22 standards in terms of the company's finances, of what

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1 constitutes a material event, if I have a company
2 with $200 million in revenue and it is break-even,
3 profitability zero, that does not mean each coffee
4 spoon is a material event. You look to other
5 measures of materiality in that circumstance.
6 And I think that's sort of the way it is.
7 Maybe somebody has the misfortune of dealing with
8 people who don't know the standards. But that's how
9 it is. And that kind of common sense stuff is the
10 way this ought to be guided.
11 MS. VIRAG: Ed Trott.
12 MR. TROTT: Marty, let me say I think
13 respectfully -- whatever that word is -- I think you
14 are confused.
15 The fact that I hire a very competent tax
16 person or a very competent inventory person who might
17 be able to do a great job in preparing a financial
18 statement or might be able to do a great job of
19 having an internal control system that includes cycle
20 count is one thing. But using the work of others I
21 believe is -- the work of others in helping the
22 auditor gather the evidence to be able to opine on

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1 either the financial statements or the system of
2 internal control.
3 I think you've confused the need to
4 increase the competence of the persons preparing the
5 financial statements, the competence of the persons
6 being part of the internal control system, and the
7 role that the auditor has to play in their audit of
8 either one of those in gathering evidence.
9 MS. VIRAG: Bob Tarola?
10 MR. TAROLA: Thank you, Sharon.
11 My concern here is the slippery slope
12 concern. In my experience, anyway, I found that I
13 generally got burned when I relied on someone else
14 and didn't -- because they were a known expert, and
15 because of that, I didn't do as much diligence as I
16 might otherwise have.
17 I think it is proposed for external
18 auditors to rely on the expertise of others, either
19 inside the company or experts that the company
20 engages, such as actuaries; but I think there has to
21 be an air of caution. I think the words in the
22 standards have that caution. So I didn't in my own

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1 thinking think it was a problem. I thought it was
2 the right balance.
3 But I think I would like to see the
4 diligence continue that the auditor as well as the
5 financial statement preparer and certifier have -- do
6 enough due diligence on the work of other parties to
7 take responsibility for it.
8 MS. VIRAG: Arnie Hanish?
9 MR. HANISH: I guess I'm a little confused
10 in listening to the dialogue. As I read the proposed
11 standard, personally I'm rather comfortable with the
12 way it is stated.
13 So I would support the board in its
14 progress to using the work of others, especially as
15 it relates to the opportunity to utilize the work of
16 others to reduce the degree of testing as it relates
17 to internal control testing by the auditors. And I
18 think this is clearly one way where we can see some
19 efficiencies and hopefully more effectiveness in the
20 internal control process.
21 So I guess I'm a little confused as to
22 where the tone and tenor of the discussion is headed.

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1 That's -- whether or not those of you that are sort
2 of articulating some of the points are suggesting
3 that we should throw this out? Or maybe I'm just
4 misunderstanding the direction that is being taken
5 here.
6 But I certainly support it and would hope
7 we would embrace it as a step forward to be more
8 efficient and effective at what we do in conducting
9 the audits of internal control.
10 MS. VIRAG: Randy Fletchall?
11 MR. FLETCHALL: To that point, Arnie, I
12 thought Ed said it very well, in terms of describing
13 the difference between the preparer and auditor. I
14 think the proposed changes, proposed standard to
15 replace AS-2 does as said remove -- if there were
16 barriers before, if there was a mindset one had of
17 using the works of an internal qualified audit
18 department, I applaud those changes. It is good to
19 get rid of anything like that.
20 Where there is confusion, though, in the
21 new proposed standard on using the work of others,
22 this seeking out relevant activities of management

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1 would suggest there's something there besides the
2 competence and objectivity and controls they have in
3 place to prepare financial statements, and suggests
4 there's something else out there.
5 Again we're chasing this Holy Grail. You
6 would have considered those other things in making
7 risk assessments to start with. I think it is
8 promising there's something more there that we could
9 take and use. Now in a bank situation you might have
10 something -- you might have a credit review
11 department.
12 But I think it promises maybe there's
13 something else out there that management is doing
14 that would constitute ^ designation alter ^ audit
15 evidence, and I think as we look -- we are having
16 trouble finding where that would be. That's where we
17 are comfortable with the existing standard on using
18 the work of others but the changes to AS-2 that
19 remove any barriers that might have been in existence
20 with respect to internal control.
21 MS. VIRAG: Unless there's more comments,
22 I think this will wrap up the subject; and actually

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1 all of the five topics we have selected for
2 discussion. Thank you. Do you want to slip one in
3 on this topic? Joe Kellas?
4 MR. KELLAS: I was sort of waiting for the
5 discussion on barriers to be ended and then take the
6 final question. I'm not sure if you're wrapping up
7 the barriers.
8 MS. VIRAG: I was going to wrap it all up.
9 I thought we got through both of those. We would
10 love to hear from you.
11 MR. KELLAS: One point on integration,
12 maybe this is why not much has been said on it. It
13 is not easy to answer on the back of the proposed
14 draft because it depends on what is in the other
15 standards in relation to risk assessment and so on.
16 When I read the draft standard, I noticed
17 references to risk of material weaknesses; and so the
18 language of risk assessment has been transplanted
19 from assessing the risk of material misstatement to
20 assessing the risk of material weakness.
21 Now, in simple terms, a material weakness
22 is a state of affairs where the risk of material

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1 misstatement is too high to be acceptable.
2 So you now are talking about risks of a
3 risk. And I just wondered how that integrates with
4 what you have on the other side of the audit about
5 risk assessments?
6 So that's where I would ask myself: Is
7 there a true integration of the two standards; and is
8 it a complication to be starting to talk about risks
9 of material weakness as opposed to risks of material
10 misstatement?
11 MS. VIRAG: Okay. At this time I would
12 like to open it up for any other discussion points on
13 auditing or on the proposals, analysis. We didn't
14 scope the subjects, but if you have other comments
15 you would like to make at this time please feel free.
16 Rebecca McEnally?
17 MS. McENALLY: Thank you. Just s very
18 brief and a very general comment. A small proposal
19 to think about here.
20 The discussion today has been quite
21 interesting. I think it has been very helpful in
22 identifying potential confusions, areas where

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1 misunderstanding could occur, with resulting audits
2 that are less than we'd like them to be, and also
3 difficulties in auditors working with managers at
4 companies.
5 But I want to raise something slightly
6 different. Lynn Turner raised an issue that I think
7 characterizes a lot of issues in this particular
8 area.
9 The audit of internal controls has been
10 around forever. When I was teaching auditing decades
11 ago -- not quite that long -- it was an issue. It
12 was in the text. It was something we taught. Yet in
13 practice, somehow, it was not at the top of the list
14 in most audits.
15 What Lynn was really saying, I think --
16 and he will correct me if I'm wrong -- is that in the
17 area, for example, of top-down, risk-based audits of
18 controls, we haven't made all the progress we would
19 like. We've been doing it for 20 years, but we're
20 still seeing problems.
21 Perhaps -- and I hope it is certainly true
22 -- we are seeing fewer problems than we would have

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1 seen six years ago. I do fervently believe that.
2 But there are still problems.
3 I see this as an opportunity for us. The
4 opportunity I see is that the PCAOB in its normal
5 day-to-day operations and functioning has a vast
6 amount of data. It has a lot of insight into what is
7 going on in the audits; and it has an opportunity to
8 move beyond the analyses that it is currently tasked
9 with doing.
10 I would like to see these analyses where
11 there are serious problems emerging, serious
12 failures, certainly serious failures, but other
13 problems as well, carried beyond the point of whether
14 an auditor failed to pick up on a problem in revenue
15 reporting, and whether that got corrected promptly
16 and whether that problem appeared later.
17 I would rather see that, in addition to
18 that, the whole process gets carried one more level,
19 one more step.
20 Why did the auditor fail to pick up?
21 Was -- and I -- at this point we get into touchy
22 territory. I'll say a couple of words; you please

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1 fill in some more silently, please.
2 Was it a matter of competence? Was it a
3 matter of experience? Were the incentives all wrong?
4 Just exactly what was going wrong here?
5 Because until we approach that problem --
6 which is really basically an issue -- we're not going
7 to know what we need to do to ultimately improve our
8 standards and to make certain these things aren't
9 happening, or at least to provide as much assurance
10 as we can. We can't get to zero.
11 You have within the PCAOB I think the
12 capability to do it; but it's my understanding that
13 it's not going quite that fast.
14 Let me be quick to say before anybody gets
15 excited here, I wouldn't -- I know what's going
16 through the minds -- I would not want to see this as
17 part of a criminal or civil proceeding. That's not
18 the proper place. What we want is a learning process
19 and, therefore, a revision to the work that we're
20 doing, an improvement of the process and not
21 primarily a fault-finding process.
22 So I would encourage the -- those in a

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1 position of authority to give some consideration to
2 it.
3 Thank you.
4 MS. VIRAG: Cindy Richson?
5 MS. RICHSON: I have a question that is a
6 follow-up to what several SAG meetings ago where the
7 topic of limitation of liability provisions for
8 auditors was discussed. This is actually a question
9 I would like John White or Conrad Hewitt to address
10 if they wouldn't mind.
11 I have heard and seen press accounts and
12 references to speeches that the SEC was considering
13 incorporating limitation of liability limitations
14 into AS-2. I wonder if that's true. I would like to
15 say for the record if that is true, which I hope it
16 is not, that would be a significant detriment to the
17 investing public and would significantly take away
18 very important checks and balance in our existing
19 system.
20 MR. HEWITT: Thank you for the question.
21 I believe the SEC probably will not have anything
22 like you described in the past. The SEC does

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1 exercise safe harbors in some of their rules such as
2 the designated financial expert, which I was for
3 three public companies. I was glad to see the safe
4 harbor, as a person, that my liability would not
5 exceed that of any other board member. I think
6 that's the type of thing that should be exercised by
7 the SEC.
8 We don't have any other plans to do things
9 like that in AS-5.
10 MS. VIRAG: Jeff Carcello?
11 MR. CARCELLO: These are from the auditing
12 standards committee of the auditing section of the
13 IAAA. They forwarded me their comment letter and
14 asked me to consider if there's anything I want to
15 incorporate into my written comments.
16 One deals with a change in consideration
17 of weaknesses; and the AS-2 had language "more than
18 remote" and now the language has changed in the new
19 standard to "reasonable possibility."
20 And the board may want to consider --
21 there is actually research on this -- as to how
22 auditors operationalize these terms. And you may

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1 want to go back and look at a 1994 paper by Amir
2 Hackenback and Mark Nelson. And the median
3 probability that audit managers use for the term
4 "remote" is 10 percent and the median probability
5 that audit managers use for the term "reasonable
6 possibility" is 60 percent.
7 That's a really big difference. Is that,
8 in fact, what the board really wants to put in place
9 if, in fact, audit managers are operationalizing it
10 in that manner?
11 Now, they don't have to. One of the
12 questions you might want to think about is, is it
13 really appropriate to use the FAS 5 framework in the
14 standard?
15 I know the first SAG meeting I came to I
16 referenced that framework. I think somebody had a
17 comment, something to the effect that it was garbage.
18 And so you might want to think about whether, in
19 fact, that's appropriate.
20 The second comment relates to a strong
21 indicator of a material weakness being a lack of an
22 independent audit committee. And you make it very

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1 clear in the exposure draft that pertains to
2 companies where the listing standards would require
3 an independent audit committee.
4 The question then I guess is even if
5 you're not required to have an independent audit
6 committee, the COSO framework when it talks about
7 control environment, which is typically the framework
8 that's going to be used, strongly emphasizes an
9 independent board, an independent audit committee as
10 a major feature of a control environment that's
11 effective.
12 And maybe more importantly than that even,
13 there's extensive research that finds an overwhelming
14 direct relationship between independent directors and
15 a lower incidence of both fraud and misstatements. I
16 refer you to work by Patty LaChow in 1996, Mark
17 Beasley in 1996, and David Farber in 2005.
18 MS. VIRAG: Damon Silvers?
19 MR. SILVERS: You know, to Cindy Richson's
20 question and ^ Con's response, I want to add
21 something that is very important here.
22 Everybody knows and it is appropriate that

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1 the SEC and the PCAOB interact a great deal on the
2 issues that they mutually face. And that that occurs
3 at the staff level, that occurs at the board level.
4 That's fit and proper and healthy.
5 However, there is, I think, a constant
6 danger given just the way the Sarbanes-Oxley Act is
7 structured and the formal relationships that exist
8 between the commission and board, there's a constant
9 danger of inadvertently people at the Commission
10 saying or doing things that might be perceived as
11 undermining the autonomy and independence of the
12 PCAOB.
13 I think from the investing public's
14 perspective, this is exactly what we don't want to
15 see. It doesn't do anyone any good when that
16 happens. And it is not a question necessarily even
17 of the reality but of the perception, what people
18 hear, what people say.
19 I have been in public quite supportive of
20 the outcomes that have occurred in the 404 area from
21 both the PCAOB and the Commission as a general
22 matter. And I hope that -- and I say that to sort of

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1 emphasize the respect I have for the Commission on
2 many levels -- but I would give some advice to the
3 folks from the Commission who are here which is keep
4 in mind how important it is to reinforce the
5 independence of this body here and how much
6 responsibility rests on the Commission and its staff
7 in relation to doing that, given the way the two
8 institutions are structured and linked.
9 MS. VIRAG: Lynn Turner.
10 MR. TURNER: A broader overarching issue
11 not only with internal control but the fraud stuff
12 we'll get into later on, does come back and begs the
13 question of, given what we're asking people to do in
14 this top down risk-based area -- especially without
15 additional guidance on certain procedures that people
16 should be looking at doing, as Craig mentioned
17 earlier -- is ultimately the question of do you have
18 people doing the work that are capable of doing it
19 and competent to do it?
20 And when you talk about making these risk
21 assessments, you're talking about risk assessments
22 that usually people with the type of experience that

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1 are sitting around the table here are used to making.
2 Yet we know, 80 percent of the hours are still being
3 spent by people with zero to five, zero to six years
4 of experience. So while they're very sharp and
5 bright and talented people, there's no way that they
6 have the ability to turn around and go do those risk
7 assessments.
8 I think you have to think about do you put
9 something in here about the fact that these risk
10 assessments have to be done at the partner level,
11 because they just can't be done by the people down
12 below. They don't have the experience. And history
13 has shown us that we're missing them.
14 I still get back to, even notwithstanding
15 that are they going to pick up on them, we now have
16 an option scandal out there that's consumed well in
17 excess of 200 companies, and there's probably many
18 more out there that probably haven't disclosed it
19 yet. Yet the auditors didn't pick up on that at all;
20 and I suspect that it's because in part, whoever did
21 make the risk assessment on those audits assessed the
22 risk low. Yet we've seen some very, very significant

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1 restatements coming through; and each one of those
2 have very serious consequences from a governance
3 perspective.
4 How would you go in, for example, if
5 you -- the recent court case on Tyson -- here's
6 Tyson, a company that their board broke an agreement
7 with the Delaware court they earlier entered into;
8 they spring-loaded options, which the court has now
9 said is inappropriate and raises the currently
10 emerging issue for auditors given that current
11 decision on spring-loading.
12 How could you even depend upon that board?
13 Given that, how could you even do an audit at Tyson
14 given that a number of those board members are still
15 sitting there at the top?
16 And certainly those are all valid
17 questions that have popped up in many of these major
18 frauds. Yet this standard I don't think asks those
19 tough questions and gives a response to them.
20 I think it is something you seriously have
21 to consider: How do we get from where we are at to
22 where we need to be on these?

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1 MS. VIRAG: I think with that we'll
2 conclude our discussion today on the board's internal
3 control proposals.
4 Is there one more? I beg your pardon.
5 MR. BECKER: To pick up on Lynn's point a
6 little bit. This standard -- it strikes me -- places
7 a huge premium on the capacity of the auditor,
8 whoever that happens to be, for risk assessment; and
9 I agree with Lynn's point that it does make a
10 difference as to who is assessing the risk.
11 I also think, though, that there needs to
12 be built into this safeguards with respect to the
13 unapprehended risk, because it's the nature of humans
14 that there's not just not going to be -- able to
15 apprehend all the risks.
16 I worry a little bit that there is too
17 much faith in the capacity of auditors to identify,
18 both at the outset and as an audit develops, all the
19 relevant risks, because we all get surprised. And we
20 get surprised with sort of startling frequency.
21 What this standard seems to be, more than
22 anything else, is all the things that auditors don't

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1 have to do compared with AS-2; and I just think it's
2 important to address the issue of the limits of
3 people's capacity to assess risk at the outset and
4 then what procedures are built into the audit as a
5 result.
6 MS. VIRAG: Thank you. For the record,
7 that was David Becker speaking.
8 At this time I'm going to pause longer to
9 see if anyone else would like to make another
10 thought?
11 Dick Dietrich?
12 MR. DIETRICH: I would like to reinforce
13 and amplify perhaps David's comments. There has been
14 research done trying to see how well calibrated
15 individuals are in assessing risk.
16 Some of the experiments go along the
17 following way: Take an event that's going to occur
18 two weeks ahead, for example. What do you think the
19 high temperature is going to be two weeks from now?
20 Don't tell me the number. Tell me a range where you
21 think nine out of 10 times you'll be within that
22 number.

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1 And it turns out that we horribly
2 mis-estimate that tolerance.
3 So we might say 90 percent of the time the
4 actual number is going to be within this range, and
5 it turns out to be 60 percent of the time. It gets
6 to this point of risk assessment.
7 And it turns out that that doesn't -- that
8 does extend also to people with expertise. It takes
9 a tremendous amount of expertise -- I think, to
10 Lynn's point, it takes a considerable amount of
11 experience in estimating risk probabilities here.
12 MS. VIRAG: Okay. So that concludes our
13 discussion on the board's internal control proposals.
14 We appreciate everybody's participation.
15 I think that was extremely helpful for us. A lot of
16 great comments. We really appreciate that.
17 As we mentioned in our briefing paper, the
18 transcript of this part of the meeting will be
19 included in the public comment file.
20 Having said that, we also encourage all of
21 the SAG members, anyone in the audience or tuned in
22 to the webcast to submit comment letters to the board

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1 if they want to provide additional insight on these
2 or additional comments. The proposal period is open
3 until the end of the day.
4 Thank you.
5 We'll reconvene at 2:50.