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

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

STANDING ADVISORY GROUP

Thursday, February 22, 2007
8:30 a.m.

The Army and Navy Club
901 17th Street, N.W.
Washington, DC
MS. VIRAG: We presented the topics of audit control over financial reporting to the SAG on several previous occasions, most recently June of 2006.

As you know, this was shortly after the board announced that it would be undertaking rule making to change Auditing Standard Number 2 and we had the opportunity to discuss with the SAG several major areas of potential change.

The input that we received from the SAG in June was an important and helpful part of the development process of that proposal.

We are very pleased to have the opportunity to obtain further input from the SAG on these proposals to consider along with the rest of the public comments that we receive. Just to remind everyone, the comment period on these proposals ends next Monday, February 26.

The topics we have selected for today's discussion are among those that have been raised in comments we received so far. We are presenting these issues here today to promote additional discussion and provide as much input as possible for the board's deliberation.

The topics we have singled out for discussion include whether the proposed standard allows for the appropriate use of auditor judgment while sufficiently safeguarding the quality of the audit, whether the proposal adequately emphasizes the importance of company level controls and the effect they may have on the auditor's testing, whether the direction in the standard on scaling the audit sufficiently addresses differences in company's size and complexity, whether differences between the process management would follow to perform its evaluation of internal control under the Securities and Exchange Commission's recently proposed guidance, and the process the auditor would follow to complete his or her audit under the board's proposed standard would result in any implementation issues. And if so, how those issues might be addressed or managed.

Finally, whether the proposed audits standard on considering and using the work of others
would meet the objective of removing unnecessary barriers to using the words of others and to promote better integration of the audits.

Additionally, we plan to have time left at the end of the discussion for SAG members to bring up any other topics related to the proposals that they believe need to be addressed.

In order to keep time for that, we plan to move through the questions by devoting 30 to 40 minutes to each topic. With that, I’d like to open the discussion with our first topic, auditor judgment.

We have two questions on the topic and you’re welcome to discuss either or both at this time.

Cynthia Cooper?

MS. COOPER: I think that the new standard is definitely going to be less prescriptive and allows for more auditor judgment, which is good.

Hopefully, we’ll start to see more reliance by the external auditors on others. It will be interesting to see how that plays out. As far as the quality of audits, I think that really will come back to the competence, to the objectivity, to the independence of the individual audit team.

And I also think that the inspection reports are going to play a key role in setting the tone. While the inspection reports I think are an excellent way to give feedback to the firms, I think it is critically important that the inspection process be in sync with the tone that we want the standard to set, because if the auditors use judgment and these inspectors come back and second-guess that, judgment, for example, obviously it is going to impact the audit going forward. In some cases, maybe that’s necessary but we need to make sure they’re both in sync.

MS. VIRAG: Joe Carcello.

MR. CARCELLO: I applaud the SEC and PCAOB for their work. In an environment characterized by intense lobbying by well-funded and well-organized groups that often were more concerned with their narrow self-interest than with the public good.

Given this political cauldron, I think both groups have crafted reasonable standards. Nonetheless, I have reasonable concerns with the exposure drafts. AS-5 is less detailed, some would say more principled, than was AS-2. And since principles-based guidance is currently in favor, this must be good.

But critically, for a principles-based regime to work, there must be vigilant and effective enforcement. Is this true? The PCAOB has adopted an inspection model, not an enforcement model. That basically leaves it to the SEC. The SEC enforcement budget has been squeezed in recent years. What is the backstop? The backstop is private securities litigation.

But accounting firms are seeking liability relief with some support, it seems, from the SEC.

And even the SEC has recently filed a friend of the court brief with the U.S. Supreme Court that would make it harder for investor lawsuits to succeed.

My overall conclusion is the PCAOB and PCAOB’s efforts would likely reduce costs without hurting good actors, but at the cost of reducing effectiveness for bad actors. Is this socially optimal? Is this in the best interest of investors?

These are the questions that I think the board should be asking itself.

MS. VIRAG: Bob Kueppers?

MR. KUEPPERS: Thank you, Sharon.

Two things to the questions on the table right now. I agree that the changes in the standard do provide for the appropriate level of auditor judgment. What we had before AS-2, as Cynthia said, was a prescriptive standard, but guidance suggesting that overlaying that is all kinds of opportunity for judgment. I think this standard finally brings into line that notion and the construction of the standard itself. I think it will give us the appropriate flexibility. I welcome and I think my partners will take the spirit of that in implementing the standard which I think will be good on the cost side.

The second question about safeguarding the quality of the audit, I think the fundamental safeguard built into the standard is the fact the standard applies equally to all entities. In other
words, it is a single standard for all, scaleable
based on size and complexity. I think size is an
interesting metric, but I think complexity is much
more the driver of how much work is appropriate in a
given set of facts and circumstances.
I think the standard has a single model as
opposed to a multiple model or other construction
that should serve if scaleability is -- I'm sure
we'll talk about scaleability. If that's
appropriately dealt with, audit quality will be
preserved and overall I think the exposure draft is
an excellent move in the right direction.

MS. VIRAG: Jeff Steinhoff.

MR. STEINHOFF: I'd like to reinforce a
couple of comments already made. I do support
strongly the move toward risk-based. I think it is a
big improvement over standard 2. This, though, on
its own -- I think Cynthia was getting to it -- does
not assure quality. It will be very important that
the PCAOB and SEC reinforce what the overarching goal
is and that is to protect the investor and to assure
there is a quality audit.

I think it is very important -- the point
Cynthia was making -- that there be a direct tie
between the standard, how the inspections are done,
and the messages that are being conveyed. The point
that was made about good and bad actors, those that
want to do the job will see this as an opportunity to
do it in a efficient and effective way. And those
who perhaps never wanted to do it will see this as a
way out.

So you want to assure that people don't
see it as a way out. They see it as a more efficient
and effective way to do the job better.

MS. VIRAG: Kimberly Gavaletz.

MS. GAVALETZ: I want to applaud the
efforts of the PCAOB. I think they listened to a lot
of things people around this table have brought
forward in a thoughtful way. I do agree with the
less prescriptive nature of the standard as written.
I believe it sets the appropriate level. It says in
a way it had to be done relative to risk-based. That
in itself will have to be evidence that the
inspectors will be able to look at.

I do share Cynthia's opening comment
relative to the concerns that tie with the
inspections to ensure that that risk base is
interpreted in an appropriate way. And really I
think you can do that by looking at how risk base is
applied and look at the process that the audit firms
are doing to try to get their judgments without
necessarily questioning the judgment underneath.
So I would -- you will have to say there
may be appropriate judgments announced in some of the
early inspections that had to be dealt with, but a
focus on the process will be important as you go
forward.

MS. VIRAG: Gaylen Hansen.

MR. HANSEN: I would also like to add my
thank you for all the hard work. I'm sure this was
very difficult to do, and we've had a lot of
discussions about that. I think there's some changes
that really will help us, in particular, some of the
definitional changes of significant deficiencies,
material weaknesses, clarifying the objective of what
we're actually trying to accomplish here. I think
going to some of the language in standard number 5 on
probability measures was really helpful from my
viewpoint.

With that said, I think there's still room
for improvement. I think on the -- all of the
language about the small business scaling and
complexities is great. How to apply this judgment,
the latitude we get and our clients get is really the
real issue.

I recognize that really defining what that
judgment means in this kind of standard is extremely
difficult, probably can't be done unless you are
approaching it from a principles-based standpoint.
And I wonder whether or not anyone has given some
thought to something along the lines of a prudent man
approach to this, a reasonableness standard that you
see in some of the legal definitions.

By that, what I mean is I am very hesitant
to approach a client and say, well, you need to add
people to your staff just so that you can provide
separation of duties. To me that wouldn't
be prudent. I probably wouldn't do it.
So I think we need some examples of what clearly would be a material weakness, some instances of what wouldn't be. And then the difficult part of this is what falls down in between.

And I do have an example that I would like to share this morning. We have a client in the Rocky Mountains, a SPAC -- a special purpose acquisition company -- subject to AS rules this year because it has in excess of 150 million in cap. And that 150 million in cap is cash. Has two employees. A few equity transactions. All of its expenses are professional fees and salaries.

Where does this fall out as far as segregation of duties and does it have a material weakness when the CFO is basically doing everything? And the only judgment the CFO has to make is whether or not the small amount of goodwill on the books needs to be impaired.

So that's an example of the things that we are dealing with in our office. And I think that may be this prudent man definition would help some of the small fillers, some of the small firms deal with the forthcoming AS-5.

MS. VIRAG: Ted White.

MR. TED WHITE: Thank you. It seems to me to be inevitable that some level of judgment is going to be maintained here. And I generally support that concept. But it also appears that the question on the table is maybe missing the larger issue which is the risk-based approach from which those judgments are based upon.

First, let me say, I think the concept is solid, and I very much like the philosophy of a risk-based approach. It seems in a resource constrained world, investors can benefit from a truly rigorous risk-based approach that is functional and accurate and gets auditors to focus the resources in the right places.

I have a simple question about the definition of risk-based and what it actually means going forward, and is it different than what people have, this sort of negative perception of whether risk-based worked in the past.

First, I'd like to understand, what are the fundamental differences going forward in how we define risk-based approach from a past -- from a top-down risk-based approach? Is it different? Are we doing the same things?

It seems that even your most recent inspection report would indicate that at least in these anecdotal cases, the assessment of risk was not making the auditor focus their attention in the correct places. They missed it. Didn't pay attention. First, is it okay to get that concept on the table under this point? Is that question fair?

MR. RAY: I'm sorry, Ted.

Specifically what question would you like to throw on the table at this point?

MR. TED WHITE: First, I'd like a basic explanation of the risk-based methodology that we would use to be making the judgment calls here. It seems to me -- first, tell me if I'm wrong in that that would really be the underpinnings of whether the appropriate level of judgment is applied in this standard? So if the judgments are going to be based upon a risk-based approach, is the risk-based approach appropriate to set those judgments?

Whether or not there's judgments or not, seems to me to be -- that's a foregone conclusion.

Auditors have to make judgments. There's no -- unless you have no resource constraints where they recreate everything -- and that's ridiculous, they have to make judgments. I'm willing to just accept that.

But it is the process that drives them to make those judgments and where they're going to apply the resources that seems to me to be more important.

MR. RAY: Well, I'll go ahead and add a commentary here. My colleagues perhaps would like to add some color to it as well and then throw it back to the floor.

But basically my view on the risk-based approach is that the concept of risk is an important aspect of many of the points through the process of conducting the audit of internal control. In order to evaluate the risk, the auditor doesn't just evaluate in a vacuum. The auditor must go out and obtain knowledge and evidence related to the various

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risks that the auditor needs to assess, then perform
a judgment about those risks.

So there is a due diligence or a due care
standard I think that would be applied around the
auditor's procedures, around the -- what the auditor
does to obtain the information necessary to assess
the risk and then support the judgments that the
auditor needs to make.

MR. TED WHITE: Uh-huh. That's not
exactly the question. Does that work? Has that
worked? Isn't that the fundamental underpinnings of
this question, this position?

MR. RAY: The standard itself does try to
provide direction around what the auditor should be
doing to satisfy that -- those requirements, that
standard, and the objectives. With regard to your
question, I think I would turn to the various members
of the group here to comment.

MS. VIRAG: Craig Omvedt, do you want to
comment?

MR. OMVETD: Just to set the stage a
little bit, I would say to you that I think the
guidance that's come from the SEC to give
management perspective on how to approach its
fulfillment of its control responsibilities, I think, is
a very positive thing.

I think the changes that you're proposing
here with AS-5 to go to a more risk-based approach is
fundamental and aligned with basic concepts of
assuring we get appropriate return on investment for
the activities that take place.

The return on investment here, obviously,
is greater investor confidence in the financials that
are being put out.

But to play off Ted's point a little bit,
I think there are modifications that we need to be
considering and perhaps institutionalize in terms of
how the auditors perform their risk assessment.

And I would suggest to you that it should
be more than simply operating within the company to
get a sense of what's the tone at the top, what's the
quality of the control process put in place.

I think there's external diagnostics that
candidly I don't think are being given enough
attention. I think things that should be looked at
would be things like sell side analysts reports,
looking at peer companies, making sure the firm and
engagement partner really understand the dynamics of
the industry within which the company is operating.

I think there's things such as looking at
company's margins. Do they make sense in the context
of the overall industry?

You know, there's evidence in the past --
and I'm not going to get into particular frauds --
but with all the competition, we're saying there's no
way in hell those margins can be right.

You ask yourself: Why aren't the auditors
focused on those kinds of things?

So I think as we think about not just this
risk-based assessment makes sense, we need to come
back to what's the guidance and what's the standards,
what are the factors that need to be considered in
performing that assessment, and it needs to go beyond
just the company itself.

MS. VIRAG: John Morrissey?

MR. MORRISSEY: I guess I'll jump around
and go back to the questions initially on the table.
I think it's important just to remind even myself
that I was not a big fan of opening up AS-2 to begin
with. I thought it was a good standard, rigorous
standard.

It was intended to be such. And I guess I
was a little concerned when I lost that debate that
AS-2 was going to be opened up. Having said that,
also, the concern is, is there enough opportunity for
professional judgment in the proposed standard? My
view is that AS-2 was fraught with opportunities to
exercise professional judgment. The words I think
were there. For whatever reasons, people weren't
reading the words and weren't following what the
words allowed people to do.

You look at the notion of risk-based audit
as being the new way to do auditing. That's nothing
new. It was available to preparers under AS-2. A
lot of companies weren't using a risk-based approach.
That's really not anything that's terribly
revolutionary.

Risk-based audit proposals, unfortunately,
were in vogue back in the late '80s and weren't executed very well. That's a concern people have to this day that it is used as an excuse to cut back on work and not focus on the quality of what you are trying to do. And risk-based approaches sometimes are done by lower level staff people that aren't in a position to have that in-depth knowledge of the business and industry in order to properly assess those risks.

If properly executed at the right levels, it could be very, very effective.

To the last point, is the proposed standard sufficiently rigorous to safeguard the quality of an audit? I think the new proposed standard neither diminishes nor enhances that notion. It will still be left up to the people executing and the auditor to look over the shoulder of the preparers and make sure the standards are properly followed.

So to answer the question, I guess I'm sort of neutral on the second one.

MS. VIRAG: Ted, we had more input. I wanted to check back in with you. Did you want to continue your remarks?

MR. TED WHITE: Maybe I didn't do a good job asking the question. I guess what I'm saying is, isn't the risk in what we're talking about here a risk-based approach? It seems to me that while it is an attractive concept, there is evidence coming from your latest inspection report that it doesn't work right or hasn't worked right. First, is that comment accepted? And what is different about the process going forward? How do we fix that? My personal opinion is that investors are accepting of a risk-based approach and can see this is a way to locate resources to where they're most useful.

But any time you have a process that has a lot of judgment calls, then each step along the way, you're relying upon thousands upon thousands of individuals in firms to make these judgment calls.

Is the inspection process different such that we can support that? Is there enough in the standard that drives that differently?

Or is there any difference? Is this approach new or is it the same?

MS. VIRAG: Sam, do you want to comment?

MR. RANZILLA: I didn't think I was next line. Let me try to address Ted's questions. I'll play a little bit off John's comments. Risk-based is nothing new, and maybe to try to put it in some context. Assume that you accept that the implementation of AS-2 was bottom up instead of top-down. We have instances obviously of that happening.

That was risk-based. I know there's horrific stories about petty cash and things like that. But the approach if you accept that AS-2 was primarily implemented on a bottom up approach, that was a risk-based bottom up approach.

The difference between AS -- a bottom up and a top down is, I mean, sort of obvious. You attempt to come from the top down, and identify controls where you can, say, that covers my risk as opposed to testing a bunch of controls down at the bottom level.

But there's nothing new about risk-based approach. To John's comments, I think there is some concern because there was late in the '80s or some period of time some approach done that way that probably wasn't implemented very well.

But risk-based is -- I mean, one, you can't do an audit unless it is a risk-based audit. There's simply not enough time in the day to do that. But the risk-based is now just the focus, the focus of coming down versus coming back up.

MR. TAROLA: I just wanted to comment on this part as well. I think the proposed standard is directionally sound. Where I think it does need guidance is in assessing risk and how one should assess risk from an auditing and financial reporting perspective.

And in my view, it's more of an enterprise risk assessment than a failure of the accounts being correct. Understanding the investor expectation, understanding concerns of rating agencies, understanding the strategy of the company, understanding the governance structure, understanding
how the finance organization works and its
effectiveness and competencies and the qualitative
factors affecting risk, I think could be built out
more in the proposed standard and serve as some
guidance to auditors in making the risk assessments.
And then in turn making the judgments as to how and
to what extent they might be performing auditing
procedures.

But to Craig's point, I think that the
external implications to risk are important. And
from an insider's point of view, an officer certifies
financial statements, I look at our risk more from an
enterprise perspective than purely from a financial
accuracy perspective. I think you could build that
out.

MS. VIRAG: Jeff Steinhoff?

MR. STEINHOFF: Going to Ted's point,
risk-based approaches are not rocket science. I
think Sam was saying that.

I think people know how to do it well. It
shouldn't be difficult to do it well. When this
group discussed this at the time that AS-2 was being
contemplated, there were a number of examples cited
where risk-based approaches didn't work well.

And I viewed all those examples as an
execution problem. Not a problem with the
fundamental nature of it.

I agree fully with John's comments which I
think should be memorialized somewhere because he hit
the nail right on the head. I think there is always
an ability to apply risk-based approach even under
AS-2. I can understand, however, the reluctance of
practitioners to do so, given the very prescriptive
nature of the standard and the fact that they were
being inspected against that standard.

And the fact that there had been a lot of
problems in recent years.

I think the real key is that a risk-based
approach does require hard work. It does require
very knowledgeable people to make the proper
judgments up front. There's skill required. Rigor
is required.

And I think it is just very, very key that
the profession, we all get it right.
But that's going to be a hard message to get through to those persons who, quote, are doing this basically from the 50,000-foot level and that influences behavior and everything else.

MS. VIRAG: Arnie Hanish?

MR. HANSEN: Let me try to touch on a few topics. First of all, let me say I believe that AS-2 -- I'm sorry, AS-5 is a giant leap forward in trying to deal with some of the issues that had been discussed and addressed over the last several years.

I think that it does -- as I think John was saying -- I believe that it was an implementation issue. I believe that the opportunity for the auditor to extend the use of appropriate judgment was there, but that it was an issue at the individual local practice level where it wasn't consistently applied.

I believe that -- maybe using an example of a risk-based approach and judgment, one of the examples that I like to use internally all the time is in the payroll area. Very seldom do you -- at least we don't find in ours, as well as large organizations, a fraud being perpetrated or a material risk that there was a financial misstatement in a payroll area.

But I believe that in at least the way it had been previously interpreted, since that was a significant level, a material level of cost and expenses embedded in our financial statements as well as the costs of our products, the auditors felt obliged to spend a significant amount of time testing payroll, as an example. The flows of payroll.

But the risk that that was ever going to produce a material misstatement was extremely low.

I believe this new standard, at least in the dialogue I've had thus far with our auditors, we can try to get out of the trenches and get up to higher levels and focus on the areas where embedded within, for example, the cost of our products, focusing in on the existence of inventory or how the costs are developed of those products that we can spend more time from an auditing standpoint focused where is the real material risk that a financial statement failure would occur, as opposed to worrying about the transactional activity as to whether or not we pay 20,000 people appropriately on a semi-monthly basis.

I think that to me is where the judgment -- auditor judgment needs to come in and be applied in this new standard. It is truly looking at where are the risks of a material financial misstatement. I believe it affords us this opportunity to have the appropriate dialogue.

MS. VIRAG: Joe Carcello?

MR. CARCELLO: I want to maybe second what Ed said and directly get at your second question there.

An overarching concern I have is what I view as the overemphasis on efficiency. Some people ask me where I'm getting that from. Let me be specific. If you look at page 3, first full paragraph, second sentence, now I quote, the board agrees that auditors should perform internal control audits as efficiently as possible for companies that are required by the SEC's rules to obtain an audit report on internal control.

And then if you go to the SEC's exposure draft, they are advocating increased reliance on management judgment. That may work well where management is competent and honest. In situations where management lacks integrity, i.e., fraud situations, increased reliance on management's judgment is going to result in management's opinion being totally worthless.

It seems to suggest the need for greater auditor assurance, but the focus on AS-5 is on increasing efficiency, not necessarily effectiveness. In my view, the role of a regulator historically is to prescribe a certain level of performance, effectiveness, that must be met by the regulated entity. Concerns with efficiency are best met via market tests. If Ernst & Young spends too much time performing the audit, fire them. Hire another firm.

Focusing on efficiency -- (laughter.)

-- or any of the other firms.

Focusing on efficiency, especially by a regulator, can easily lead to insufficient audit work.
and a decline in audit quality which is your second
question.

MS. VIRAG: Bob Kueppers.

MR. KUEPPELS: A couple points. We all
want to make sure Ted is satisfied with his good
question about risk-based. Let me point out that the
judgment areas don't aren't limited to the initial
assessment of risk.

And I say initial, because let's assume
you're doing a first audit and you go through your
process to try to concentrate your testing in areas
of greatest risk. As you go about the work, you will
find your initial assessment needs to be adjusted and
updated. Some of the areas you viewed as risky might
turn out to be otherwise and some other categories
you had in a low category might contain more risk as
you learn more and perform related testing.

The judgment cascades throughout the
entire standard including the decisions on the
nature, time, and extent of procedures that flow from
that initial risk assessment.

And I think that one of the things you
might speculate about is if you don't use a
risk-based approach, what's the alternative? The
alternative would be somehow test across the span
of the population, if you will, at the same level.
And I think over time, the profession, the GAO,
others have used a risk-based approach appropriately
to focus the testing where the greatest risk lies.
But that is a -- that's an analysis that needs to be
updated as you go through the course of an audit as
you learn more.

Second point I have is as to the
sufficiency point, I don't think, at least from my
firm's standpoint, and I think probably the other
major firms as well, that we're getting the wrong
message. I think that the thing that troubles me
about the efficiency point and wouldn't bother me to
see it in adopting release language and things like
that, I don't think it is a good idea to have it
embedded in a standard.

I think standards generally should --
historically and in the future -- should represent a
minimum level of work that needs to be achieved.

When you introduce efficiency as a requirement, that
may work most of the time, but we all have situations
that are frankly difficult. And you may not get
their efficiently, but you may get to the end of the
journey as is needed.

If in fact this doesn't protect investors,
then we wouldn't support the standard. And I think
that all that said, the reason we're supporting the
standard as an improvement is we think it will be
easier for our partners to implement with the
appropriate guidance from the firms. And I think it
does preserve the investor protection requirements in
the Act.

MS. VIRAG: Randy Fletchall?

MR. FLETCHALL: First, Joe likes to do a
lot of research. In research, you come up with
hypotheticals. I'm sure what he was giving was a
hypothetical about a particular audit firm doing too
much work and the market would react.

This goes back to Ted's question, but to
what Bob said, and Craig said about the need to
understand the business and industry in which an
audit client is operating. That is clearly important
to a risk assessment.

What you have to be careful about is
thinking that is in lieu of actually understanding
how the financial statements get prepared and where
there might be errors or material errors. So that's
kind of incremental. I just don't think we should
got into the thought that if I understand the
business, I understand the industry, to Craig's
point, I don't see anomalies, therefore I conclude
everybody is right.

Clearly if you see anomalies, that
requires work to determine if you have a problem. As
we talked -- Sam mentioned, look how we do
methodologies over the years. If we got into
problems back in, say, the late '80s or '90s, it was
trying to take too much of the fundamental out and
focus on if I know the business, I know the industry,
the company looks healthy, maybe I've done an audit.
That's not necessarily the case. That's where we had
problems. Yes, it is important. It is essential in
an audit to understand the business of the company
and where it operates within its industry, but you can't infer from that that therefore the financial statements are correct and I don't have to do other work.

MS. VIRAG: John Kellas?

MR. KELLAS: First of all, I want to say without commenting on the details, the general direction towards a slightly more principled, slightly higher level standard seems to me to be absolutely right. I think my general approach would be to start at as high a level as is consistent with improving and creating good practice and necessarily make the standard more detailed if inspections, for example, indicate that that is necessary.

There was a comment about judgment and the need not to second-guess the judgment of the auditor.

I think that there's obviously truth in that. It is true, judgment should be allowed to flourish. At the same time, I know regulators elsewhere are concerned that judgment is used almost as a trump card.

One point we are keen to make is auditor judgment is not that trump card, but it is to be a reference to what other experienced auditors might do in similar circumstances. So there's no one answer to anything. But on the other hand, there must be ranges of reasonable and maybe there's something that ought to be written into the standard along those lines.

Just picking up the efficiency point, it is right that standards are concerned with quality first and foremost rather than efficiency. I think a standard setter, any regulator, cannot ignore efficiency. And if one of the problems with AS-2 has been inefficient implementation, it may not be just dealt with in the way that Ed indicated by amending the current standard. But it may be that there's something about the current standard that breeds a certain inefficiency, albeit that all the right words are in all the right places.

Sometimes it is easier to start again and to indicate that fresher approach, provided you accompany it with the message that Ed was concerned about, that you should not be portraying this as some how a rather relaxation, but a different approach to a quality audit that will promote efficiency while maintaining the quality.

MS. VIRAG: Lynn Turner?

MR. TURNER: I'd echo the comments that Dr. Carcello made as well as those that Ed made. I think -- as well as the question that quite frankly Ted asked, but never got an answer to.

We have been doing these type audits for the last few decades. SAS 55 came out in 1988. It is not like it is something new. It is the exact approach we used on many of the audits that have failed miserably and resulted in mega claims against auditors, not without reason.

So I think there is a concern, because when I compare the language in SAS 55 with the language in this particular document, what I find this is document is similar, but if anything lacks some of the guidance in the old AS-5 and certainly the guidance in the old audits guide. I know the auditing standards board did a nice job of trying to update that recently. Maybe that's something that needs to be taken a look at as well.

But it is a continuation of exactly what we've been doing, and there is nothing in there that indicates really any significant change despite the fact that there was a fairly thorough study done in the '98, '99, 2000 timeframe in the O'Malley panel report. If you go back and read the O'Malley panel report, all the major firms sitting around this table at that point in time did indicate they weren't doing this notion of top down and stop, they were in fact doing a full top down risk assessment.

And the O'Malley panel came back and found that there were two problems, a couple of problems with that standard. One involved the attitudinal issue and something has to be changed in the standard if we're going to address attitudinal issues and how auditors were approaching the risk assessment, which clearly hasn't happened because if you look at the last 4010 report, we see people not showing up for the brainstorming session required by the audit standards board.

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

MS. VIRAG: We'll go to Craig Omtvedt.

MR. OMTEVD: Thanks. I just want to add a couple of comments. First, I think in terms of the concern about this being viewed as a relaxing of the standard, I can tell you that for those of us out in the field, no one views it in that light. I think universally we all view it as an opportunity to have better quality audits and be more effective. I think one of the concerns with AS-2 and anybody who has done any degree of auditing will tell you if you are looking across the board at everything equally, you are going to dilute down your effort and you're not spending your time in the areas that are critically important. I think, again, the modification you are making here is going to allow for much more qualitative audits. I personally think one of the things we are all grappling with here -- and I want to lay this out a little bit -- I think we have an audit approach today, playing off of Joe's point, that assures the good people are effective in trying to do it right. I don't think we have an audit process today that helps detect the bad people intent on doing it wrong. And by that I say that as we look at the audit approach today, first we look at, do we have control processes in place to see that transactions are recorded properly?

Do we have a financial organization with a sufficient understanding of GAAP to prepare the statements in accordance with GAAP?

And at the end of the audit process, we get opportunities to improve our control processes and correct errors. Again, the people who are trying to do it right get assistance in getting it right. But when you have a situation of management override and outright fraud, I would offer up that the audit approach as it stands today is highly ineffective in detecting those kinds of situations.

We had somebody be here -- I don't remember his name -- who six months ago raised the whole issue of how are we approaching the whole aspect of fraud in the risk assessment process in the audit process. And I would suggest to you that until we get that sorted out and get that right, all you're giving people in the certification is comfort that those who are trying to do it right got it right and they've given you statements in accordance with GAAP. I would offer up from an investor's standpoint, I would suggest that the certification should be -- and these are my percents now, so I'm doing something ballpark -- the certification is probably should be 30 percent, that the financial statements are correct and proper and in accordance with GAAP; and should be 70 percent assurance that there isn't a fraud.

Now, I accept the fact that people aren't going to catch everything. But I would say to you today, the audits are woefully inept in detecting fraud.

MS. VIRAG: We have time for two more
commenters, Charles Noski and Cynthia Richson.

MR. NOSKI: I am probably one of the few people who has listened to everything this morning and can say I agree with almost everything I've heard. I've been an auditor. I've been a preparer of financial statements.

Today I sit on several boards of directors and chair two audit committees. I am listening through my filter as an audit committee member and trying to think about how AS-2 and AS-5 affect what I do and how I think about the work of the auditors whose client I am.

The thing that strikes me that is going to be important if you go forward and adopt AS-5 is that there needs to be a much more robust dialogue between the independent auditors and the audit committees about the risk judgments and the risk assessments that the auditor is making, because my concern will be -- as I listen to this -- and, of course, what I've heard from both preparers and from audit firms is that AS-5 is actually viewed as an expectation for a much reduced level of work and more risk-based.

And I, too, can remember back to the '80s and '90s where that was code for doing less work and being more competitive and reducing audit fees.

Having been a preparer and an audit partner at one point in my career, I have different perspectives on audit fees. As audit committee chair, I have different perspectives on audit fees because I am now more interested in the effectiveness as well as the efficiency in the audit.

So I do think that as you think through the communications between the audit firms and their clients, the audit committees, that there should be a much more robust dialogue about those judgments because as audit committee members and as board members, we are focused on risk assessment and risk management and we spent a lot of time looking at, frequently at some companies, looking at the performance of audit companies versus others, and trying to understand why we are better or worse than the performance of others and challenging management to explain to us why the financial statements reflect the reality of their business and their performance.

So please don't forget the audit committees and our needs as you reflect upon the requirements that you're proposing in AS-5.

MS. VIRAG: Thank you.

Cynthia Richson.

MS. RICHSON: Thank you. The discussion this morning has been very insightful and very interesting. I agree with a lot of what's been said. But I do think Ed sort of hit it on the head.

I've been talking to a lot of audit committee members, independent directors, and I think the perception out there is really that the PCAOB is relaxing the internal control standard and the testing standard; and I think that's a very big problem.

I think part of it -- even I, when I first learned about this -- was surprised that the PCAOB didn't say we've got two years of inspection reports under our belt, of which, of course, only part of that is public and parts are not. So we don't have the full story even sitting here. But that they weren't going to tweak it to make it more effective and efficient. Instead it is a brand-new standard.

I think that's feeding into the perception that this is -- the companies have complained loud enough and often enough that we need to do something about this crisis. And in talking to audit committee directors and members, basically I hear horror stories -- and these are widely circulated -- about how the auditor came in and spent the entire day looking through my day book to make sure that the meetings I said happened really happened. In other words, a complete waste of time.

And so you say, gee, that doesn't make any sense. That strikes me as being very wasteful. On the other hand, some good points were made by Ted and Lynn.

I don't think any investor who ultimately bears the burden of cost of these audits has complained. For the most part, it is about audit quality and that's where the focus ought to be. When I hear the focus on the new proposed standard is business efficiency, while we're all very 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 unrepudiated 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.

16 (Pages 58 to 61)
We're going to take two last comments and then cut this discussion off.

Gaylen and then Arnie has a comment, and then we'll be done.

MR. HANSEN: I do agree with you. I don't think we have gone overboard with that. I can say from a CPA perspective that this standard is telling us that we should apply more judgment. But I just went through an inspection where almost every single comment was addressed and critical of the judgment that we did apply.

So I think there's a balancing act and that is where the inspection process comes in to play.

And I -- then just briefly, we had some discussion about the audit committees and their oversight function, and I think it's very important that they be utilized properly. And in this process, it can't be overstated how important that is.

I've seen a huge improvement in the functioning of audit committees and the role that they play. But on the other hand, I don't think you can expect audit committees to do everything to identify management override and reduce to an acceptable level what might be going wrong within these companies.

You can't expect the audit committee to be the back stop here. And so if that's what we have in mind, I don't think that works. And especially not some of the smaller filers where some of them don't have audit committees to rely on. I think that we need to kind of rethink that.

MS. VIRAG: Arnie?

MR. HANISH: I guess -- I'm trying to figure out how to frame this.

I find it regrettable that many people around the table are trying to sort of tear away at what I think the staff and the board have done an admirable job of trying to address, issues over the past several years that have been brought forward.

I would challenge many of the people around the table to maybe try to get into the trenches and understand where some of the criticisms have come from from the companies. It is in our best interest as a company to make sure our investors have the utmost confidence in our financial statements.

We look to our internal processes and people preparing those financial statements to ensure those financial statements are accurate and present fairly the financial position and condition of our companies.

But the way these audits were implemented is where the rub is. And I just really don't know how many of you have ever in recent years been in the trenches to see the incredible level of detail we are being put through.

We can talk all we want at high levels about risk-based approach. But put yourself in the position of us within the company having to deal with some of the -- what I'll call ridiculous questions that were being posed to us because there wasn't a lot of judgment being exerted or commented on the part of many of the auditors.

I think these words enable us to have the appropriate dialogue with the auditors to get them to focus and help them focus on areas where there is the greatest risk.

And I guess maybe we need to -- as SAG members -- have an auditing 101 lesson for some of the members around the table to get people to really experience what some us who are sitting here as preparers have really complained about for the last several years.

We're willing to pay whatever it takes to create a situation and an environment where the investors truly do have confidence. But the level of detail and the lack of focus on those areas where many of us believe where there was a significant risk of a material misstatement was really misplaced. And I think this enables us to get the focus in the right direction to provide what you all who are investors want, the high quality audit that's efficient and effective.

Thank you.

MS. VIRAG: At this point, I'm going to put up the questions for the next session and people can be thinking about those and we can kind of move on to that.
I see we already have a tent up. I'll call on Damon.

MR. SILVERS: I apologize. I'm still on the last session. I hope you'll indulge me. I think Arnie's comment about who's in the trenches deserves some sort of response.

In my capacity at the AFL-CIO, I have a variety of duties. Among them has been advising a preparer who was attempting to comply with 404, and doing so voluntarily.

And I am deeply aware of what Arnie is talking about. I have experienced it firsthand. The AFL-CIO and I personally have been very determined in the dialogue about section 404 and AS-2 to be clear that we sympathize with much of what we have heard from the preparer community by what appeared to people of good faith about unnecessary burdens being imposed.

And for that reason -- among others -- we were supportive of the general direction which the PCAOB and the staff took in considering changes to AS-2. And I think if you Google or whatever our

comments in relationship to this process, you will see that's where we have been.

And I don't think we're alone in that.

The Council on Financial Investors is in a similar position. I think most thoughtful, long-term investors had a similar point of view. Unnecessary expense and unnecessary distraction from the business of running companies is not in our interest.

What's happened, I think in the last few weeks as people have -- as people have read carefully the proposed draft standard is that -- and I think this reflects perhaps the tone of Arnie's comment about people tearing things down.

What's happened here is that a number of concerns are being raised from a number of expert quarters, more expert than I -- academics, auditors -- about what the implications are of certain phrases in the proposed draft standard.

In particular, the implication surrounding the question around the issuance of the reliance on the work of others and on the ability -- on whether or not all -- either issuers or auditors are being

instructed, encouraged, hinted that merely the conclusion that somebody at the top of the company seems like an honest fellow is going to be enough to -- is going to be enough not to have to actually look at actual controls.

I'm not enough of an expert to be able to get deeper into these things, but I keep getting ambushed by people who I think are to my right and turn out to be on my left on this and it makes me uncomfortable.

I want to reiterate my support for the work of the board and the staff around this area which I think has been admirable, and has done great credit to the board and the expectations Congress had for the board when it put it in place. These issues being raised are serious ones and are what the comment period is for.

We believe that the foundations, the conceptual pillars, so to speak, of what is being done here are correct. The board and staff need to be vigorous in rooting out any of these hints that under a new AS-2 or AS-5 auditors or preparers are going to be allowed to look the other way.

MS. VIRAG: Joe Carcello.

MR. CARCELLO: Before I make my next comment, let me reiterate something I said to some people yesterday. I think on balance the standard is a good standard. But I don't think we bring a whole lot of value if we come here today and just applaud you.

So what I'm trying to do is point out things that I think are at least worth thinking about. And so that's what I'm trying to do.

One comment I have related to this question and this again interacts with the SEC's guidance. The SEC's guidance talks about a strong indicator of a material weakness and ineffective oversight of financial reporting by the audit committee. And I clearly disagree with that. But no guidance is offered in either the SEC exposure draft or AS-5 as to what ineffective oversight looks like.

I think this is particularly problematic because no evidence -- no evidence that I'm aware of, maybe you guys are aware of some -- that auditors are
proficient in evaluating audit committee oversight of financial reporting.

And there's an actual conflict, given that the audit committee now has the authority to hire, fire, and compensate the external auditor. Also relating to company level controls is the whole discussion we had this morning by a few people about fraud. I would agree with what Craig said. I think this is a major issue.

In your exposure draft, there's a quote from Craig Jonas that there needs to be increased controls on fraud. I clearly agree with that. I think AS-5 should have a more robust discussion of this issue or the PCAOB should accelerate its possible reconsideration of SAS 99, especially given the numerous -- and as Lynn said -- really rudimentary deficiencies documented in the board's recent 4010 report.

MS. VIRAG: Okay. I forgot to read the question for everybody. The company level controls discussion is based on the question, does the proposed standard adequately articulate the appropriate consideration of company level controls and their effect on the auditor's procedures?

Bob Kueppers?

MR. KUEPPERS: I didn't think you were serious about this question. I was going to answer the last one. So I might as well take the license you've given me.

I guess I want to make one point. Maybe a final point hopefully on this issue of tone.

If you compare AS-2 and the exposure draft AS-5 and look at things like, well, principle evidence is gone, a large portion disappeared, you might be able to -- you could turn that to be that we don't have to do much work in order to issue our opinion.

But I'm not troubled by that simply because where that leaves us as auditors is that we need to have sufficient competent evidential matter to support our opinion. That is true for the financial statement audits. It is the same standard.

By introducing, as AS-2 did, new terms, you know, I think all of that does not signal to me opposed to going beyond.

I think what you're going to see in our comment letter and other comment letters is a couple things. The interaction between the management guidance from the commission and your guidance and perhaps this is one area if you look at the guidance there's some actually very good discussion in the SEC's guidance with respect to the direct and indirect level of company level controls, and the impact that would have.

And then you look at the PCAOB standard and where the level of precision -- actually paragraph 43, if you look at paragraph 43, it is not necessarily in the assessment, it is in deciding how much to test. Right?

And perhaps that needs to be moved up, and that should be part of your assessment. So that drives the decision-making around, you know, how aligned the company level controls are, your evaluation, and then determine the nature, time, and extent of your procedures.

This is a very delicate plan where I think
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<td>15 able to consider what they do and to have the</td>
<td>15 MR. RANZILLA: Well, this may be the first</td>
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<td>19 and extent of your procedures.</td>
<td>19 MR. FLETCHALL: I agree with that.</td>
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<td>20 MS. VIRAG: Randy Fletchall?</td>
<td>20 MR. RANZILLA: But I would say that if</td>
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<td>21 MR. FLETCHALL: Thank you, Sharon. This</td>
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<td>10 controls, if financial statement assertions are</td>
<td>10 controls, we're able to discern the difference</td>
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<td>11 correct.</td>
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<td>12 So I think it is one of those areas,</td>
<td>12 and those that are indirectly linked to assertions</td>
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<td>13 again, if you clearly have ineffective company level</td>
<td>13 which have very different effects on our audit</td>
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<td>14 controls, an auditor has a lot of work to do. Where</td>
<td>14 approach. And then even those that are directly</td>
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<td>15 you think you have effective company level controls,</td>
<td>15 linked to the assertions, is the precision there</td>
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<td>16 again you can't infer that that means transactions</td>
<td>16 close enough so that you can ultimately conclude that</td>
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<td>17 are processed correctly and everything is accurate.</td>
<td>17 little or no more work is needed on that company</td>
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<td>18 I made the statement in a SAG meeting, a</td>
<td>18 level control.</td>
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<td>19 couple of SAG meetings back when we had a panel</td>
<td>19 I think how the auditors implement that</td>
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<td>20 talking, going back a few years ago to when we were</td>
<td>20 aspect of AS-5 would depend upon whether we're coming</td>
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<td>21 looking to become more efficient and looking at</td>
<td>21 back here in two years having a discussion about the</td>
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<td>22 methodology. We looked around the world, very hard,</td>
<td>22 need for more efficiency or the fact that we just</td>
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20 (Pages 74 to 77)
don't get it and we're not doing enough work.
And so my suggestion is that that is a
place where the SAG could provide maybe some more
guidance in terms of -- and I think -- I can tell you
for a fact, my firm would be willing to participate
in some sort of practice aid or the like, because I
do honestly think as I look at my own firm's
implementation of AS-5, that is the place where we're
either going to get it right or we're not.

MS. VIRAG: Jeff Steinhoff?

MR. STEINHOFF: I'll let go of Sam's
echoing of Randy's remarks. This is a very delicate
area. It tells you a lot if they're bad. So if the
high level controls are bad, you know you've got a
serious problem. It tells you less if they're good.

They are somewhat difficult to assess. I
think probably more guidance is necessary. Probably
more guidance is needed in order to tell an auditor
where their reliance would enable them to reduce
testing.

And it perhaps is not clear what evidence
one must pull together to support the assessment
itself, much less the reliance on it and reduction.
I do have a concern that the way the standard is
drafted, people might think that there's a lot of
focus on this versus other things. And I think
somewhere in the standard, in paragraph 17, as it was
noted to me, the auditor must test the company level
controls, very definitive.

And I think a lot of auditors will read it
as if this is really the keystone. And once I tested
those, and I find those are all right, I can greatly
limit everything else I do.

I'm not sure that's what you want to
convey, but I do have a concern that there's a need
to have a proper balance and to perhaps provide some
more guidance in this area either through the
standard or in another way.

But to make it very, very clear what this
tells you and what it doesn't and how much priority
and how much weight the auditor must place on this at
the end.

MS. VIRAG: Richard Dietrich?

MR. DIETRICH: As an academic, my role

often is to ask a question. So in thinking about Ed
Trott's comments earlier, and in this message that it
sends, and Kayla's comment, when I look at this
issue, my question is, do we think that this proposal
is intended to increase the effectiveness or the
efficiency? And if we think it is really intended to
increase effectiveness, it would be helpful to
explain how we think it will do that.

Otherwise, it will be interpreted as
increasing efficiency by telling the auditors if you
do this, you need not do other things.

I think that's the point that is being
made here.

MS. VIRAG: Lynn Turner?

MR. TURNER: As usual, I agree with Randy
and Sam.

(Laughter.)

MR. TURNER: Nice articulation, Randy.

But I think there is a risk here that goes back to
some of what Craig said earlier about risk at the
company level or whatever, and how that translates --
how then the auditor translates that down into more
of the detailed basic work.

Once again, there's less guidance in this
standard than what was in the prior standard, and
even the prior standard didn't work. And under the
prior standard, we know time and time again that the
auditors were unable to make that assessment at the
top. And yet you're making that assessment at the
top very, very key, and I actually think it is very,
very key.

If it isn't working there, so far as I'm
concerned, you can cut it off there and forget about
testing the rest of the stuff and go on from there.

It is a total waste of time to be doing that. And
yet at the end of the day, when we look at all the
various cases and you can name one after the other,
you know, for whatever reason, that never got
assessed right. And yet as we heard here not too
long ago, this standard really hasn't changed and
isn't different.

So my question is, why are we using the
same standard that didn't work that people were never
able to assess, and where we are given less guidance
than before? What is it that we are looking at to turn around and say that it didn't work? Maybe back again to some of Craig's comments about the fraud stuff. It doesn't seem to be there's enough focus on those controls that deal with fraud.

Quite frankly, this gives you almost no guidance, very little definition of what is meant by the control environment where the audit committee is so key. There's hardly a mention of the audit committee in this particular one, and the importance of that role and what the expectations are with the auditor with respect to that.

So again, it looks to me like we are very much close to what we've had for the last 20 years, which I suspect will give us pretty much the same result in the next 10 to 20 years. I just wonder why we're going down that path unless we want to repeat history, which it seems like we are destined to turn around and do with this document.

By the way, Arnie, I sat on three audit committees and gone through this nitty-gritty in the last few years and chaired three. I appreciate what you say. I agree that you don't want people going overboard, but this standard is a repeat of history.

MS. VIRAG: Cynthia Cooper.

MS. COOPER: I agree with most of the comments made. It is dangerous when we rely on company controls to reduce the amount of substantive testing. I think that is one of the reason that some of these big frauds in the past have not been detected through the external audit that I think the frauds like WorldCom, Health South, other big scandals are more likely to be detected through more rigorous substantive testing and more forensic audits.

I think it is important to make sure that while auditors are testing company level controls, we don't forget the risks we are trying to meet.

Everything should go back to risk in the end, and we should make sure we keep our eye on what these company level risks are.

One is management override of controls, collusion that goes all the way to the highest levels of a company. That's one thing we have seen consistent with most of these big frauds. And in my view, there are very few controls, when you have collusion and override, that will prevent these frauds and detect them.

I think it is important we be in agreement with what will prevent these controls, perhaps fraud hot lines to prevent these frauds and make sure we don't use reliance on controls as an excuse to decrease our substantive testing.

MS. VIRAG: Kimberly Gavaletz?

MS. GAVALETZ: I want to reflect on prior conversations we've had relative to this topic and some of the key points that I think you've tried to include in the standard revision relative to the timeliness and the timing of when you looked at the company level controls.

I think one of the points we haven't quite discussed in here was early in the process. We've alluded to it, saying that basically you look at something, decide not to test. I think it is important that some of our prior conversations said these weren't focused to the end where they might have been able to help with the scooping.

I tend to agree if they're really good, you don't have to test. If they're really bad, they do give you signals and that's where you need to go.

What I heard was there were a lot of experiences and this might have changed through the last year or so, but a lot of experiences with company level controls being looked at at the tail end of the audit, which I felt was inappropriate and didn't give you the information. They're very informative from the outset. That is an important part you have to have incorporated.

I think Lynn touched on it. Whoever does this, it is very important to really look at the company level controls and to discern what's really being told by that. It will take a lot of senior level support to go do the level of substantive testing which I agree is necessary to really get to the foundation of things.

It also involves looking at what the audit committee role is. There is a little bit of conflict
1 And so when things go wrong, people aren't saying how could it be that the business failed to provide this. But again, that doesn't do the audit work. It is the basis of good audit. I think the control environment, upper level controls are in exactly the same category. They deserve more focus than they've had in the past.

2 But they are underpinning a good audit not substituting for other matters.

3 MS. VIRAG: I'm going to go ahead and put up the next question. We'll get started before the break. We have 12 or 13 minutes before then to start with comments on scaling the audit.

4 The question is, does the discussion of size and complexity within the proposed standard appropriately describe when and how the auditor should scale the audit?

5 Joe Carcello?

6 MR. STEINHOFF: Yes.

7 MS. VIRAG: I promise to call you next, Jeff.

8 MR. STEINHOFF: I said yes. That was my comment.

9 MR. CARCELLO: I have a few comments on what you guys are suggesting as it relates to smaller public companies. And one of the things suggested in the exposure draft is that small companies' control objectives can be met through daily interaction of top management. For maybe most companies this will work.

10 What if senior management is corrupt? For example, we know from the research that fraud is more prevalent when the founder is involved with top management. That's been well documented. Smaller entities are likely to have continuing founder involvement.

11 So that would seem to be a risk to me.

12 The exposure draft also suggests that inquiry and observation of a control may provide sufficient evidence of whether a control is effective even without documentation. If fraud is going on, top management is not going to tell you that during an inquiry. The very fact of observing behavior changes that behavior.

13 In there that has already been pointed out.

14 I think it is a place that does need to be focused on at the right time in the overall -- by the right people and rightly resourced, so you can get the most impact out of it. Otherwise, if you're doing it, I'm not sure what the reason you're doing it. If everybody is external to it and independent of it, it is another check. But a potential leap too far down in the process.

15 MS. VIRAG: John Kellas.

16 MR. KELLAS: Thank you.

17 Perhaps I stumbled slightly over paragraphs 16 and 17. One reason was the reason Jeff raised. I stumbled over the must test. It is wrong to read that sentence without reading the whole of it because you do say that they are important, blah, blah, blah.

18 I think when we were revising the international risk standards a few years ago, we came under a great deal of pressure to acknowledge that company level and overarching controls were capable of providing the auditor the assurance they needed.

19 At the end of the day, we did resist that.

20 I think our position is much closer to what Randy said at the beginning.

21 They are a very negative indicator, if they're rubbish, but even though they're brilliant, they are unlikely to do your work for you. At the end of the day, the only question to be asked about control is, is it good enough to achieve the objectives I'm looking for.

22 I think you say that in your document somewhere if I remember correctly.

23 That's the point to be focused on rather than -- well, as I say, read the whole sentence. It did make me think maybe the message was a little bit strong on the overarching controls.

24 It is rather like the point Lynn raised earlier about knowledge of business, external information and so on. I think if there's one -- you know, over my years in auditing, one thing I think I came to the conclusion that is really, really important is that the auditor understands the business program.
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<td>Finally, in my opinion, the standard seems to suggest -- although I will recognize it is not explicitly stated -- that smaller entities can get by with relatively unsophisticated financial reporting staff. But even if a business enters into simple transactions -- no derivatives, no leases, no defined benefit pension, post-retirement benefit plans -- they still will have deferred transactions, and they'll still have to prepare a statement of cash flows. FAS 109, 1048, FAS 945, not to mention any applicable EITFs and staff positions are complex standards requiring high level skills. MS. VIRAG: Jeff, did you want to comment more than your yes? MR. STEINHOFF: No. (Laughter.) MS. VIRAG: Gaylen Hansen. MR. HANSEN: As I read the standard, it appears to me that scaling applies to all companies. I think the standard says it does. It is not just small companies. I'm not sure it really articulates.</td>
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<td>how that works, other than it is based on risk which I think that should be the approach. Then just to speak to what was said by Jeff, I mean, I agree with the idea that you have to have competent people internally. But let's face it, in a small business, in the small companies, it is really 95 percent people and 5 percent systems and not the other way around like in the bigger entities. I mean, I do know that there are specific technical issues that have to be handled by those competent individuals, you have to have internally. But it is not as pervasive in the larger companies. So I think the idea of scaling is what is going to make this work for the smaller businesses. Some of them don't have deferred taxes. I know my clients don't because they don't make any money. They're losing money. I wish they had deferred taxes. 109 is particularly difficult for them. MS. VIRAG: Richard Dietrich? MR. DIETRICH: Two questions about this. One, I am unsure about the word &quot;size&quot; in there. Bob Kueppers mentioned it earlier in his comments. It seems to me that that's making somehow implicitly an argument about cost-benefit analysis of the internal control testing relative to the size of the company. Alternatively, the term complexity that's used is really talking about the need for evaluation and judgment. And I think of those things as very different. It is quite probable they are correlated. Smaller companies may be less complex. But I think those two things, at least in my mind, are muddled. The other thing Gaylen Hansen mentioned earlier was this two-person entity. And so I asked myself what if one of the two people quit. And then we had a one-person entity. Do we really have to say that we expect every entity to have effective internal controls? What if it is a one-person entity? MS. VIRAG: Damon Silvers? MR. SILVERS: When the question comes up, do we really expect every entity to have effective internal controls, that's like hitting a button. Before I do my automatic playback on that subject, I want to say a word about just the way in which the board approached this issue of scalability. As a conceptual matter, I think this is exactly -- as a broad conceptual matter, exactly the right way to do it. Not to say some companies the auditor ought to have a scaled approach and others they shouldn't, or anything like that. And also not to fall into the trap of saying that any particular financial metric is a proxy for complexity. There are relatively large companies that are relatively simple and relatively small ones that are relatively complicated. Financial service companies that are small may be more complicated, and a biotech start-up might be large on a market cap basis. So I think this is an area -- my prior comment talked about getting the foundations of the pillars right. I think this is an area, together with the notion of shying away from a design audit approach, and a few other areas, where the board and the commission have gotten this right. Again, I think we need to be wary here.</td>
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that in the interstices and details, the standard
messages are being sent that somehow smaller or
simpler companies shouldn't be audited.
And that a perfunctory kind of -- that it
is okay for either the company's assessment, the
SEC's business, or the auditor's audit ought to be
kind of a pro forma exercise. It absolutely should
not. I think if the collective opinion of those who
know best is there are any words in this that point
in that direction, they ought to be changed.
Now for the auto-play part. Anybody who
wants to have access to the public's money, whether
it is a one-person company or a no-person company --
right -- should be able to say they have adequate
internal controls. I do not believe that anyone
should be allowed to call up one of our union members
on the phone at home and offer them a security for a
company which does not have adequate internal
controls. I do not believe anyone can say they
should with a straight face.
Thank you.
MS. VIRAG: Leroy Dennis?

MR. DENNIS: I want to comment a little
bit on some of the things Joe mentioned. I agree
with him. I'm concerned about the messages. I
support the standard and where it is going. When I
look at smaller companies, complexity is going to
drive what the words are going to do, not necessarily
the size. A company that invests in its controls,
whether it is a small company or a large company, is
probably going to have a more efficient process
performed by the auditors.
But if I look at a smaller company that
has -- where you are relying on management to make
sure controls are implemented properly, and to your
point of how do you test management, you've got to
rely on the audit committee. The audit committee has
to be more effective probably in that environment
than in an environment where you have much more
robust transactional controls.
If you have a situation where you don't
have that oversight of the management by an effective
audit committee, I think you're going to have
proportionally more harm done than a company that
does have those controls. I think the messages have
to be that this is really in the company's control as
to how much they want to invest in their systems.
And if they invest the proper amount, as
their shareholders would want, then they could have a
more effective process. If they decide to invest a
minimal amount, I would guess proportionally their
audit fees and the opinion to get to the control is
going to go up.
MS. VIRAG: We are going to go to break.
When we come back, I will start with Ted and Lynn.
Everyone can give thought to the question.
MR. RAY: Before you get up from your
seats, one thing I neglected to mention in my opening
remarks this morning is that we do have time set
aside beginning at 5:00 o'clock for emerging issues,
if there are any. I have not received any
suggestions for any issues that we ought to discuss
in that session to date, but if you have any you
would like to discuss, please see me during one of
the breaks and we can see if we can get that teed up.
With that, we do have a half an hour
break. We'll see you back here at 11:00 o'clock.
Thank you.
(Recess.)
MR. RAY: If everyone would please take
your seats, we would like to resume the meeting.
I declare the break officially over and
turn the floor back over to Sharon.
MS. VIRAG: I think we will start with Ted
White.

MR. TED WHITE: I had a quick statement on
the question. First, I agree with the statement. I
agree with the approach. My single comment here is
that I would urge the board and the staff to
resist -- even strongly resist -- any approaches that
would, under the guise of scaling an audit, come up
with a two-tiered process or anything that has lower
standards just because a company is small.
I believe what Damon said is that size and
complexity are two separate issues, and you can't
assume because a smaller company is small, it is less
complex and vice versa. Both of those concepts
should be included in this standard, remain in it.
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| 1 And I'm a little bit worried -- I guess a\n| 2 lot worried -- about pressure on the PCAOB to scale\n| 3 an audit down, meaning giving lower standards to\n| 4 smaller companies. I think that's wrong. That's it.\n| 5 That's my statement.\n| 6 MS. VIRAG: Bob Tarola?\n| 7 MR. TAROLA: Thank you, Sharon. I think\n| 8 the concept around scaleability, looking at risks and\n| 9 focusing appropriately on those risks, allowing the\n| 10 company to show the auditor how they do control risk\n| 11 is the absolute right direction. I think it applies\n| 12 to all size companies.\n| 13 I think it is an effectiveness improvement\n| 14 across-the-board that the focus on the higher level\n| 15 controls on the enterprise risk will allow the\n| 16 auditor, I believe, to more effectively conduct an\n| 17 audit, more effectively identify the areas where real\n| 18 work is needed to make sure that management is doing\n| 19 a proper job on serving its investors.\n| 20 I think the trade-off between a better\n| 21 understanding of enterprise and high level risks will\n| 22 result in some conclusions that previous testing at\n| 23 lower levels may not be necessary. In my view,\n| 24 that's also an effectiveness conclusion and I'm\n| 25 supportive of where the board is going here.\n| 26 I think, however, the perception that it's\n| 27 purely for efficiency is an incorrect perception. It\n| 28 is really an improvement in effectiveness.\n| 29 MS. VIRAG: Other comments?\n| 30 Craig Omtvedt.\n| 31 MR. OMTVEDT: Just a couple of thoughts\n| 32 here and I will get back on my soapbox on 404 for a\n| 33 moment. I want to reiterate the point I made earlier\n| 34 this morning. I really truly don't believe that\n| 35 there's an audit process today that is effective in\n| 36 detecting fraud, and I think that there should be,\n| 37 and I believe that is the principal interest of the\n| 38 investment community.\n| 39 I think what we have today is a process\n| 40 that -- again, as I said earlier -- I think assures\n| 41 the good people are getting it right. I would\n| 42 suggest to you that what has happened here is that in\n| 43 place of effective audit procedures for getting at\n| 44 fraud, we have substituted a 404 standard that says,\n| 45 well, if we do a lot to document all the controls at\n| 46 a grass roots level, then we really can be pretty\n| 47 well assured that we will not have fraud. I would\n| 48 suggest to you that the opposite is quite the case.\n| 49 I think if you look at the body of\n| 50 evidence, it would say there has never been a major\n| 51 fraud as a result of poor control of inventories at a\n| 52 plant location or the potential is somebody wrote off\n| 53 5 or 6 million dollars of inventory because they\n| 54 weren't determining obsolescence. I think, further,\n| 55 the problem we have here is because of the standard\n| 56 we have in 404 today, we have an issue in our public\n| 57 markets in that foreign investors don't want to issue\n| 58 here because of the expense and the difficulties\n| 59 associated with trying to comply with 404.\n| 60 So as I look at the situation, I think\n| 61 that if we move to get stronger and better standards\n| 62 for detecting fraud, I believe that if we deal with\n| 63 the whole issue of 404 and scaling that to a standard\n| 64 that makes more sense, we then will do a great deal\n| 65 in resolving the disconnect we currently have between\n| 66 how the standards are working for large public\n| 67 companies and how we ultimately will deal with small\n| 68 companies.\n| 69 Thanks.\n| 70 MS. VIRAG: Lynn Turner?\n| 71 MR. TURNER: First, let me correct the\n| 72 record that the reason companies aren't coming here\n| 73 has nothing to do with complexity. Two major Wall\n| 74 Street firms, Goldman Sachs and Thompson Financial in\n| 75 recent weeks have indicated that regulation has\n| 76 nothing whatsoever to do with that in this country.\n| 77 Having said that --\n| 78 MR. OMTVEDT: Excuse me, but I refute that\n| 79 for the record.\n| 80 MR. SILVERS: Go call Goldman.\n| 81 On the complexity issue, in a way, this\n| 82 ties back to what we talked about earlier in terms of\n| 83 translating what you think of the people at the top\n| 84 and the job they're doing into how far down you go\n| 85 and what you do, including not only in small\n| 86 companies but big companies.\n| 87 And when you think back to a typical\n| 88 audit, probably most of us would assess things like
PP&E additions and intercompany accounts as low risk.
And yet those were the items that were actually
manipulated at both Health South and WorldCom and
we've heard discussions about accrued payroll and
accrual for vacation allowance were two of the
accounts manipulated at Qwest to turn around and make
the numbers.

So one of the complexities that the
standard really doesn't adequately address or get
into is how is it that you translate -- how is it
that you go about making that risk assessment and
make sure that you don't make the same mistakes that
others have made, that those type of things are
automatically low risk. And I don't have to spend
much time on them when, in fact, some of those
accounts have turned out to be, very, very
problematic.

And I think there's very little --
actually, there's probably no discussion in the
document, if you will, about the fact that you may
have items that you typically would assess at low
risk and most people would assess at low risk. And

yet in reality, they turned out to be extremely high
risk and been evident in multi-billion dollar
misstatements that have cost investors tens
of billions of dollars.
And somehow this document needs to come to
grips with that issue and talk about the fact that,
you know, just because you or I may think it is low
risk doesn't necessarily mean it is. You need to be
thinking about that and that's where in the O'Malley
panel report, they did a nice job of saying that's
where the auditor that's thinking about putting on
that skeptical hat, and is that type of situation
potentially existing here. You don't have that here,
which, quite frankly, takes us back to repeating
history again.

MR. OMTVEDT: I apologize for speaking out
of turn here. But, Lynn, back to your point, I agree
with your point. But the issue here isn't the
absence of control, it is more a case of management
override. And once you have management override or
you have collusion to circumvent a control, then you
killed the effectiveness of the controls that were

there in the first place. And that's back to my
point about we need better fraud detection
methodologies in the audit process.

MR. TURNER: I think in a lot of cases
that's true, Craig. But in the WorldCom case when
you started to look at the intercompany accounts --
and Cynthia probably knows this better than me -- you
didn't have intercompany accounts capturing the data
in the way controls need to capture the data.

That was just not override. That was the
type of systems and the information in a company that
you didn't have especially in light of all the
roll-ups and consolidation that occurred.

MS. VIRAG: Damon Silvers has his sign up.
We'll move to him.

MR. SILVERS: Many years ago, I had the
experience of sitting in a small room at the
Securities and Exchange Commission without any
windows.

(Laughter.)

NEW SPEAKER: That was special for you,
Damon. There are only two of them, but they have

very bright lights.

MR. SILVERS: That's right. I was sitting
on John's side of the table, so to speak, in that
room. Hopefully, John will stop me if I say anything
I'm not supposed to. It was a long time ago.

And there was an individual on the other
side of the table --

MR. TROTT: Stop.

MR. SILVERS: There was an individual on
the other side of the table who neglected to ensure
that his firm had counted the inventory in the
warehouse. And that individual was crying. Turned
out -- I think it wasn't his responsibility to see to
it. But that failure to do so allowed other people
to misrepresent what was in that warehouse, and there
were serious consequences to the investors in that
modestly sized public company.

That's why we need to have a standard here
that will basically direct both companies and
auditors to do their very, very best to figure out
what's important and what isn't, and not presume that
it isn't important if it turns out that it might well
In the case of WorldCom, the other thing that went wrong is the external auditors really shared too much information in terms of their scope with management, so they lost the element of surprise.

What happened was when they told management we're coming in to test construction in progress and here's how we're going to test it, a lot of these entries were sitting in CIT. Management went in, moved the entries around in small dollar increments that would be less likely that the external auditors would detect it.

And the other thing that Andersen did was they relied heavily on analytical review. So they would come in each quarter and look at line costs as a percent of revenue and compare that with prior quarters and everybody was in line. It was flat at 42 percent. Andersen looked at it and said there are no anomalies, everybody looks good. They didn't compare it to a peer company like AT&T and others which I think is an excellent suggestion Craig mentioned. They did little substantive testing because they relied on the strength of internal controls.

For example, in the area of property, they only had six capital additions in the first half of the year and none in the second half of the year based, in my view, on over-reliance on internal controls.

So if any of you guys have questions you want to ask me, I'd be happy to answer them.

MR. RAY: I think this discussion about fraud is very enlightening. You will have a chance to talk about fraud this afternoon at our session. Maybe if we can -- I think we need to try to focus on these questions that we have teed up. I think this is a very important one to make sure we are heading in the right direction on the scale. If we could try to focus on this, that would be very helpful.

Thanks.

MS. VIRAG: Ed Trott.

MR. TROTT: Why do I need this section in the document at all if I'm using a risk-based approach? Wouldn't that cover all those 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
number of comments and I believe that's where the
staff thought that some of these things needed to be
addressed to answer where there was more work going
on than needed to be done. Not to let there be less
work, but to allow the people hang up on specific
words to see their comments and to incorporate
guidance that I felt was sufficient on its own into
this standard being separate, which I also thought
was sufficient.
That being said, we are at the point where
we have something on -- out there, and I think it is
there. It is trying to be clarifying. I do believe
overall it might have been an overstep to give a new
number to the standard. It is implying it is so much
more drastically different, and I do believe it was
to incorporate some of these subtleties that I
believe were already in the document.
Relative to that, I think relative to
size, the question that is up here, we already had
the flexibility in there. I agree with John. But if
that unintended consequence that people see the
tiered approach, because I think in some cases
smaller companies, you may have to do additional work
in areas that you wouldn't have done because they
were done a little differently.
So we are where we are. I think we have
listened to folks. There was the cry for some
clarification. The staff has answered that cry. We
need to clean up any unintended consequences from
that, but move forward without, you know, a major
revamp of the activities.
I think that's actually what you presented
to us, though it has been labeled in a much grander
scale.

MS. VIRAG: We have about five, maybe 10
minutes left on this subject. I'm going to try to
get everyone whose tent card is up. Joe Carcello?
MR. CARCELLO: I think in general, the
standard is pretty well written. The one thing I
would suggest for you to think about, though, is on
paragraph 9, the note, footnote number 6, where you
make specific reference to size cutoffs.
On the SEC advisory committee, on smaller
public companies, I'm afraid that could be misused by
people. I'm afraid people could look at that and
say, well, you're below a certain size cutoff without
really thinking through rigorously the issues of
complexity. And it is very likely a company could be
below those size cut-offs and be complex and really
should have an audit scale up and vice versa.
And although the standard certainly talks
about that, by putting in specific dollar amounts
with the imprimatur of an SEC group, although this
was privately funded, I think runs the risk of being
potentially misused.

MS. VIRAG: Lynn Turner?
MR. TURNER: I agree with Ed's question
and Arnie's answer. I think if you're really serious
about a principle-based type of approach -- which I
agree with -- I think you start taking yourself very
much so into a rule-based approach when you start
defining here's the size of companies, putting in
numbers. There's no way at that point it isn't
principle-based, it is rule-based, and you start to
lose it.

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

The fourth bullet on reporting.
Come back and tell -- here is the objective we expect you to achieve in reporting. This is another area where this is very much rule-based. You give the auditors one reason why is particular type report, you don't give them flexibility. You talk about giving them judgment, latitude to tell the public something about controls if they think there's something that needs to be. Put those objectives right up front and lay those out. It gives you more flexibility in the later part of the document to have more room for judgment. They know what they have to come back and achieve. It increases your ability to use judgment but tells everybody what they have to get to and what they will be held accountable to at the end of the day.

When you get there, you don't need this two tiered standard which you have in this case, one for small, one for large. I certainly encourage you to go down that path.

MS. VIRAG: Gaylen Hansen.

MR. HANSEN: As I said earlier, as Arnie pointed out, I think maybe changing that title to make sure that people don't get misled, that the scaling related solely to small companies would be something to -- footnote 6, I don't understand what that did anyway. It is sitting there. Sort of gives you an idea of sizing. But how it translates to the standard, I'm not quite sure. The only other point I had to make on this particular issue was I think the same thing could be said of the multi-location testing. At the point -- back on -- in AS-2, when the standard sort of said that you had to cover a larger portion, and then that's taken back, that's in the same boat with what Ed's talking about.

This is risk-based. You're going to make those decisions on all locations. Under that sort of principle-based approach, that wouldn't be any different than any other scaling decision.

MS. VIRAG: Bob Kueppers?

MR. KUEPPERS: I wanted to pick up on a comment Kimberly made about not needing to renumber the standard. I don't think anybody has picked on Ed yet. I think we should call this AS-2-R and I think it should be just fine.

MR. TROTT: Which firm are you with?

MR. KUEPPERS: One substantive comment. I hear the debate about the -- I don't believe this is two standards in one cover. I really don't. The question of whether or not you should call out or have separate importance to the smaller company, I think is one that is the result of all the sensitivity and the politically charged environment around this.

We know the SEC is determined not to exempt. We have to find a way to make sure the thousand companies that are not yet in the system have an audit approach that is AS-5 compliant at the end of the day.

The one thing this might provide, though, is a portal to plug in additional guidance at the small end of the spectrum. I'm not talking about size. I'm talking about complexity. I think that's the biggest driver. I think it might be helpful if all the audit firms that have not done one of these audits yet because their clients are in the non-accelerated filer category, additional guidance for getting it right at the less complex company level, this would be the place in the standard that guidance would sort of plug in.

I think that small business audit guide, even though in principle I'd love to have one thing and have the whole continuum be scaling. I think we need to provide extra help for a big part of the population that is not in the system under 404.

MS. VIRAG: Damon Silvers?

MR. SILVERS: First, I want to echo what Bob just said about the appropriateness of that kind of guidance for the non-accelerated filers. I think that most investors look at the non-accelerated filers and say we want the same principles to apply to everybody, but in real life, when people are doing things, it looks different when you talk about a company of 30 people than a company of 30,000 people. That's just a different thing. There ought to be some help to the firms and to the companies that
having guidance -- I know it is here -- whether
there's other guidance being worked on, I think could
be helpful.
Specifically, though, I think we had a
lengthy conversation about the risks of company-level
controls, and the degree of directness or
indirectness, the risk of how much that would either
drive no testing or the nature, time, and extent of
the type of testing of process level controls.
I would ask that you take that
conversation and marry it to what is in paragraph 12
about whether or not we are helping or hurting in
some of that.
MS. VIRAG: The next subject is a
discussion of the differences between management's
evaluation process as management would follow it
based on the SEC's proposed guidance and the process
the auditor would follow under the board's proposed
standard. The question is would management's process
for evaluating its internal control under the SEC's
proposed guidance and the process the auditor would
follow under the board's proposed standard raise
misunderstanding that this section constitutes, as I
think Bob just said, two standards under one cover.
There's got to be absolutely no ambiguity
about that question. It is one standard. Right. It
provides -- allows the auditor of the mega company to
talk about the relative complexity of the mega
company compared to other mega companies, but does
not give any special breaks to the auditor of the
small company in terms of the standard.
So I think to the extent that the title,
for example, leaves any ambiguity, that title needs
to be altered.
I also think with respect to the footnote
issue and the issue of throwing numbers anywhere,
there needs to be greater clarification that while
certainly numbers like market cap and total revenue
are relevant to the question of complexity, they're
not determinative.
MR. COLMAN: I just want to support what
was said by Bob and Damon, to be able to say there's
a standard and a standard and scale it all the way
down. That said, there's unique characteristics,
weird stuff. Either too good to believe or just off.

Some of that stuff you get through doing things like monitoring. Not just testing.

So I kind of have to say I like the SEC's extra verbiage and allowance. I think from being down in the details, seeing what's happened both on management's side and public accounting's side, when I was with Lowe's, it is a big sigh of relief to have other options than doing testing to make sure the control environment is really what it appears to be.

MS. VIRAG: Kimberly Gavaletz?

MS. GAVALETZ: I would agree with Howard's comments relative to a broader spectrum of evidence that supports -- that management has a control environment. The one concern I still will echo to the group is keeping the ever increasing potential for divergence between what the SEC guidance is and what the PCAOB's.

This reconciliation going forward is something we're going to have to be very vigilant about. I applaud the SEC for keeping it sufficiently almost principles-based. I know there's a clamor for more detail from others. I would hesitate in telling people exactly how to do the things. I think you tried to do that. I hope we don't keep doing that.

I think that gives more potential for things to diverge.

I would just lay out as an indirect answer to this, as we stand right now, there are kind of the right levels, but I see that it exists out there, there's the potential long term and we're going to get very -- to not let that occur and keep the reconciliation and test ourselves before either is released on making sure those are clear, so we don't confuse the management side of the things that are trying to implement. And then the external auditors who are trying to assess management and then getting things out of sync. We do have the potential for that.

MS. VIRAG: Randy Fitchell?

MR. FLETCHALL: There clearly are differences between the PCAOB's proposed standard and SEC's proposed guidance. But let's face it.

Management is in a different place than auditors.

They are there every day. They are running the company. It makes sense. One of the criticisms before was auditors were driving management to do things because there was only AS-2.

To the extent there are differences, that's probably good. A concern would be if there are so many differences that people can't communicate and we have gaps or duplication because as we manage these total costs down, I can go back to, Charles, what you said earlier, about your role as an audit committee member.

We think it is terribly, terribly important to make sure there is a thoughtful collaboration between management teams who we might have turned into auditors, let them manage, but take on the responsibility they have under 404 and certifications as Bob said to do what they do well.

There is optionality, flexibility. All the effort might be reduced in some way, so what a management team chooses to do will have an effect on what an auditor does. What we are preaching to our people is a thoughtful collaboration, sharing of details.
process. I think everybody agrees with that. Some
of this is like we talked about this morning around
the implementation.
That said, there are a couple of areas
where I do think it would be helpful to have just
from an efficiency standpoint, whereby when the
auditor comes in, they're speaking from the same song
card. One was -- we touched upon before, the
discussions around the entity level of control, the
degree of precision in the PCAOB standard and the
documentation that is in the SEC standards. Elements
in both of them are very good. I think coming
together would really help the process ultimately
from both an effectiveness and an efficiency kind of
standpoint.
Second, around the strong indicators of a
material weakness. There's breakages between the
two. I think some people could think there are
subtle messages being sent through there. I'm not
sure there are. I think it needs to be -- have
collaboration about -- so that the management's
trying to decide what are material weaknesses and

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

I further believe that the discussion of
important risks should be held with the audit
committee to make sure the management team and the
outside auditor are in line -- or in alignment as to
all of the important risks. And, in fact, how
they're going to be -- how they are mitigated and how
we will each do our job in making sure that we can
provide a certification we have to provide.
The -- heretofore, there has been very
little collaboration. It has been pretty much a
gotcha situation. My hope is we can somehow avoid
that and management teams and auditors could
basically work together to protect investors by
agreeing on important areas to review and
complementing each other in some way toward achieving
satisfaction that risks are appropriately mitigated.

MS. VIRAG: Jeff Steinhoff?
MR. STEINHOFF: I think it would be normal
to have some differences in the way this is stated to
the respective parties. Management has a much
different responsibility than the auditor has. And
it's important that management realize that it is the

one responsible for ensuring there be adequate
controls. It is a fundamental management role.
It is not a process management should be
going through to comply with what an auditor wants.
It is good business practice. It helps protect the
business as well as the shareholder. But it is a
fundamental management responsibility.

So if that is always placed in mind, then
the auditor's role is to provide a check over whether
management is reasonably carrying out its
responsibility and it shouldn't be the auditor
driving management. And both parties should be
really having a constant dialogue as to those things.
We have faced some of that at the federal
government, where management just solely wants to
find out what does the auditor think. So if the
inspector general or GAO has issued a report,
management will jump right on and report that as a
weakness. They feel in some quarters as long as they
have done that, they are compliant with the laws.
That is very far from the truth.

They have a responsibility to assure on an
ongoing basis that things are working well, and I think that it's all right for the language not to be exactly the same in every paragraph. And as long as there's a clear understanding, I think this can work well.

MS. VIRAG: Any other comments before we move on?

I think we're going to break for lunch at this point a few minutes early. If everybody could meet back here at 1:20 that would be great.

(Whereupon, at 11:51 a.m., the meeting was recessed, to reconvene at 1:20 p.m., this same day.)

AFTERNOON SESSION

(1:20 p.m.)

MR. RAY: I would like to restart the meeting since most people are sitting down. If the remaining few could please take your seats, I will turn this back over to Sharon Virag to continue our discussion on internal control.

MS. VIRAG: The next topic for discussion is using the work of others. We have two questions. You can take them in any order you like.

First, does the proposed standard meet the objective of removing unnecessary barriers to using the work of others?

Does the proposed standard promote better integration of the audits?

Joe Carcello to start us off.

MR. CARCELLO: Since no one else wants to talk, I'll take the microphone.

Again, I think what you have here is reasonable in many ways. I guess the one concern I had is in AS-2, at least my read of AS-2, there was a clear demarcation in my mind between relying on the work of management and relying on the work of internal audit, particularly internal audit that follows the standards for the professional practice of internal auditing.

I thought that was a good demarcation. That seems to have gone away in AS-5.

In the discussion paper you gave us to prepare for today, you have a statement in there essentially focusing on competence and objectivity, which I agree is the focus. It is not on the job title. I agree clearly that is by far the least important. I don't know if I completely would ignore it. In my mind, job titles do matter somewhat because they create a mindset.

I think there is a fundamental difference in mindset between internal audits and management because they may involve compliance with a set of professional standards. When you rely on the work of internal audit, there's in many cases a set of professional standards, a certification, a code of ethics, a code of responsibility that those people in many cases have internalized and they're also bound to observe.

That's not necessarily the case when you rely on management. So I think kind of equating them is potentially dangerous.

I think the language that you had in AS-2 was in many ways better than what you have here.

MS. VIRAG: John Morrissey?

MR. MORRISSEY: I would like to -- first of all, I agree with everything Joe just said.

I think looking back on my days as an internal auditor, the internal audit function can be very, very valuable to an organization. As you mentioned, they have their own ethics requirements, professional standards; and in a properly structured, organized audit function where they report directly to the audit committee, they are in many ways accountable to the audit committee and investors directly.

I think this is something that really deserves serious attention and recognition that it's worth investing in an internal audit function from a public policy standpoint. And to elevate them --
I'm a little concerned with the principal evidence provision being eliminated. It's not necessarily that I think that the wording in AS-2 was necessarily right. Again, I always kind of go to the end point and worry about the potential consequences. I asked some people this yesterday; let me pose this to the group. If management personnel appear objective and competent, could they gather the principal evidence, and not just for the audit of internal control but for the financial statement audit? That really worries me.

With the audit of internal control, if we do not get that right, that doesn't automatically mean there's a misstatement in the financial statements. But if there's a problem with the financial statements and we don't get it right, there's no backstop, no safety net. It is a change not just for ICFR but a change for the audit of the financial statements.

Here we're saying we can rely on management to essentially do the work to audit the financial statements if they appear objective and competent. If so, if that's true, what do we need the auditors for?

And roll back the clock to the late Nineties. Don't you think most everyone would have described Mr. Fastow and Mr. Sullivan as honest, as competent, if we were sitting here in 1998?

MS. VIRAG: Sam Ranzilla?

MR. RANZILLA: I'm not prepared to answer that question, Joe.

(Laughter.)

MR. RANZILLA: Hypothetical.

I'd like to address two things. One is the concept of principal evidence and, secondly, the proposed auditing standard on the use of the work of others.

With respect to principal evidence, I support the elimination of those words. My own belief is the elimination of those words doesn't do much, if anything; and if they were driving behavior that wasn't appropriate, which I think at best is anecdotal evidence, then I think that's fine.

There's been a notion of principal...
evidence in the auditing standards long before
Auditing Standard No. 2; and it will continue to be
one of the implicit standards in an auditor's ability
to sign an auditor's report that says in my
opinion -- not in the opinion of management, and not
in the opinion of the internal auditors -- but in my
opinion, these financial statements are blah, blah,
blah, or this internal control is up or down.

So while I support the notion of removing
the words "principal evidence," I don't think it's
changed the auditor's responsibility with respect to
its ultimate objective.

With respect to the use of the work of
others, I don't support the issuance of standard
number 6, if we're going down that path. I think
that the board has made the appropriate changes
through auditing standard number 5. If there were
impediments to the issues that might have been
leading to less than optimal use of others in an
internal control audit, I think those have been
amended; and that coupled with existing auditing
standard number 65, I think is, in my belief, exactly
where we want to be with respect to the integrated
audit.

MS. VIRAG: Lynn Turner?

MR. TURNER: Once again, I'd agree with
those last comments of Sam.

I think the current standard that we've
got up there is fine. If you decide to go to in the
direction that you're headed, then I think you got to
couple it with being transparent to investors. I
think you need to first off clarify in the standard
that takes any of the burden off the auditor to
ensure they gain sufficient evidence that they
themselves have enough that they can conclude, and
that we're not going to hear cop-outs later on about
"well, that was done by the internal auditors" or
anything like that.

So I think you need to make it very clear.
I would do that, once again, by going and laying the
principles out right up front, in bullet form, and
note that one the principles is you have to get
enough evidence from the testing to form your own

conclusion. You know -- at the end of the day I
don't have a problem if people want to use internal
audit. And pursuant to what John said, it is -- to
the internal audit department, because we know we
have some that are very good and some that are really
lousy and some that are somewhere in between.

That's where I think the SAS 65 on use of
specialists, as it exists, is already very good. It
talks about those situations and how you have to deal
with it. I don't see this as being an improvement on
that. I don't know why you do it. That's why I
agree with Sam.

But then I would come back and say in the
report, if you're using someone else to do part of
your work for you, I would like to know that as an
investor. Just as we require the auditors to tell us
if they're relying on work of others on the audits of
the numbers in the balance sheet or income statement,
and we note that, I think they should note that here,
too, and give us a heads-up.

I can only think of one reason you
wouldn't be able to tell us and that's not a good

reason to leave it out in the first place.

MS. VIRAG: Damon Silvers?

MR. SILVERS: I think there's a principle
here that the board ought to follow in relationship
to these issues, which is the principle of the
integrated audit. That the degree of reliance which
an auditor can place on the work of others in the
control audit ought to be conceptually the same
degree of reliance an auditor is allowed to place on
the work of others in the financial statement audit.

I don't know the terms of art that get you
there, but I think that's the principle that you
ought to be following.

I think that the creation of a separate
standard on the work of others would suggest
something else is going on; and so I don't believe
that that's an appropriate thing to do.

And I believe, by the way, that this is an
area where a great deal of danger lies. I would call
the board's attention to the words of the statute,
section 404 which -- an attestation as to the truth
of the assessment by the independent auditor.
That points at what's really going on which is the independent auditor is slapping their 
stationery on management's assessment. At that 
point, somebody is violating the statute. 
And the -- more -- from law to real life, 
right? -- the risks that everyone involved in 
creating such a situation would bring upon themselves 
would be very dramatic, in relationship to the day 
when a large company would explode as the result of 
such a thing.

I can guarantee you if that were to 
happen, and if somebody cab walk into a courtroom 
with a defense lawyer and point to the standard, and the 
standard allowed me to rely on the 
preparer; I should be able to walk out of this 
courtroom free of liability and not in handcuffs," I 
can guarantee you the judge will say that standard is 
inconsistent with the statute and whatever you say 
those words mean, they don't mean that.

It would be far better to get the words 
right in the first place.

Ms. Virag: If there's no other thoughts

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Mr. Singer?

MR. SINGER: I might have some confusion about this point. When I read it, I was a little 
confused. I'm a little confused by the discussion.

When we talk about the work of others, we 
had a discussion, I think two meetings ago, about 
whether there ought to be different standards for the 
work of specialists who were internal versus 
whether there ought to be different standards for the 
work of specialists who were internal versus external. And it seemed that there was a potential 
of having some unnecessary barrier to having work 
done by, let's say, an internal tax specialist.

What I'm unclear on is, is there actually 
an objection here to having an outside audit firm 
rely on the work of others in the area of cycle 
reviews? It's just a matter of --

And, indeed, isn't one of the goals of 
Sarbanes-Oxley to impose a standard of excellence on 
your internal finance capabilities, so that more of 
this work is done internally?

It may be that there is liability in 
having an outside auditor rely on some of that work.

On the other hand, it is a reasonable expectation 
that management develops its resources to accomplish 
this work.

I am really confused. I know Mark 
mentioned earlier he's reluctant to have people from 
the PCAOB comment on this; but I would actually like 
some helpful comments in this area about the degree 
to which we're discussing this.

I mean when we audit, for example, 
inventory, is there really a question about your 
public company auditor being able to rely on the work 
of others in cycle discounts? Or are we going to 
drive that level of work up to an outside vendor?

So I have perhaps some misunderstanding of 
this issue, and understanding the degree, but some of 
this discussion seems a little bit contrived as a 
real world problem, at least to me.

MR. RAY: Let me comment just very 
narrowly. I think your example was a good one. The 
cycle account example, as I read the standards 
currently, my reading is if the cycle accounts are 
done periodically throughout the year by internal 
auditors, the independent auditor may look at that 
work and evaluate it and decide whether they're going 
to use that work as it relates to the nature, time, 
and extent of work they need to do with regard to the 
existence of inventory.

I think if that work was done by somebody 
else, it's unclear as to whether the auditor would be 
able to use that work.

But I'd certainly welcome other views on 
that point under the existing standards again.

MR. OMTVEDT: May I offer you a 
perspective on that and stay with your cycle count 
example? At the end of the day, as a starting point, 
the cycle counting is part of our management controls 
just to be comfortable that our inventory systems are 
working.

I think one needs to differentiate between 
what's happening in the normal course of day-to-day 
activities versus perhaps a situation where we have 
the internal audit group going in to an audit on a 
management location to test the quality of the 
controls.

I think you really have three tiers here.
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

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

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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<tr>
<td>1. reasonable approach to doing it; it does not take</td>
<td>1. about perhaps the paragraph on -- paragraph 9 which</td>
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<td>2. the responsibility off the auditors or shareholders</td>
<td>is sufficient competent evidential matter. Marty,</td>
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<td>3. at all. At the end of the day.</td>
<td>your point, Sam raised, if standard number 6 is going</td>
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<td>4. MS. VIRAG: Marty Singer?</td>
<td>to stay, to bring these concepts -- and Lynn brought</td>
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<td>5. MR. SINGER: I agree with those last</td>
<td>this up -- I just thought it might be helpful to know</td>
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<td>6. comments. I do want to comment on Lynn's statistics.</td>
<td>what it says. It might help this conversation a</td>
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<td>7. We had this discussion before. It is not surprising</td>
<td>little bit.</td>
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<td>8. after the implementation of Sarbanes-Oxley and 404,</td>
<td>It basically says for assertions related</td>
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<td>9. there were disagreements between management and</td>
<td>to material financial statement, where a risk of</td>
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<td>10. outside auditors on what was acceptable. The game</td>
<td>material misstatement or degree of sub-activity</td>
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<td>11. changed. There were new definitions of process. So</td>
<td>involved in the evaluation of audit evidence is high,</td>
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<td>12. these statistics are somewhat artifical.</td>
<td>the auditor should perform sufficient procedures to</td>
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<td>13. The other issue is, of course, a lot of</td>
<td>fulfill the responsibilities described in earlier</td>
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<td>14. these discrepancies revolved around the process</td>
<td>issuer opinion. In determining these procedures the</td>
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<td>15. associated with smaller companies, an issue this</td>
<td>auditor gives consideration to results of work,</td>
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<td>16. group is less and less sympathetic to, as you want to</td>
<td>either test of controls or substantive tests</td>
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<td>17. get rid of any sort of departure from one size fits</td>
<td>performed by internal auditors, and those particular</td>
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<td>18. all.</td>
<td>assertions, however, for such assertions, the</td>
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<td>19. But the issue, of course, for smaller</td>
<td>conversion of internal work cannot alone reduce audit</td>
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<td>20. companies was the issue of materiality, another issue</td>
<td>risk to an acceptable level to eliminate the</td>
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<td>21. we discussed. I was talking to Vince earlier, and he</td>
<td>necessity to perform tests of those assertions by the</td>
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<td>22. mentioned this as an important issue. You have small</td>
<td>auditor.</td>
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<td>1. companies with GAAP earnings near zero and, for</td>
<td>1. I think this is right on point to what is</td>
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<td>2. example, in our case, we had a $50 million antenna</td>
<td>missing -- performance -- in AS-6 to clarify it. It</td>
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<td>3. business, $2 million inventory. $50,000 of</td>
<td>4. is very subtle in paragraph 9, where you need to</td>
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<td>4. discrepancy was a material weakness, because it</td>
<td>5. obviously have sufficient evidential matter to issue</td>
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<td>5. wasn't mentioned against the asset that was important</td>
<td>your opinion. This perhaps would clarify.</td>
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<td>6. to shareholders, it was measured against GAAP. Okay?</td>
<td>6. I think this is the point at when people</td>
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<td>7. If we are losing a whole lot of money it would have</td>
<td>8. are simply saying could you go back to what was in</td>
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<td>8. been immaterial.</td>
<td>9. the old standards, I think that's what they mean by</td>
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<td>9. That was one of the delights of this whole</td>
<td>10. it. It would be a really helpful clarification.</td>
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<td>10. process. There were definitions of material</td>
<td>11. MS. VIRAG: Damon Silvers?</td>
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<td>11. deficiencies or weaknesses that I think were somewhat</td>
<td>12. MR. SILVERS: I think the issue facing the</td>
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<td>12. artifical; but again, I agree with these last</td>
<td>board is the question, not of whether or not we want</td>
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<td>13. comments. It doesn't suggest at all that the auditor</td>
<td>to build internal competence within issuers; I think</td>
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<td>14. abdicates responsibility. What it suggests is that</td>
<td>15. we all do. Marty's question is yes, we want</td>
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<td>15. you have learned competence on the part of management</td>
<td>competence here and want technical strength. But the</td>
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<td>16. in these areas, not learned dependence.</td>
<td>dilemma that faces the board what is to do about</td>
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<td>17. And management has to be for improving its</td>
<td>18. essentially the fact that no matter how good you are</td>
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<td>18. processes. Here it is like cycle counting and other</td>
<td>19. as an internal auditor, you are not the independent</td>
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<td>19. audit practices.</td>
<td>auditor.</td>
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<td>20. MS. VIRAG: Vin Colman?</td>
<td>20. And how to guide the independent auditor</td>
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<td>21. MR. COLMAN: You know, I just thought it has been mentioned a couple of times in the confusion</td>
<td>21. in such a way that they can both make use of</td>
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<td>22. in the confusion</td>
<td>22. information that's generated from internal expertise</td>
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Washington, DC
February 22, 2007

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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. TROT: 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 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.
That's -- whether or not those of you that are sort of articulating some of the points are suggesting that we should throw this out? Or maybe I'm just misunderstanding the direction that is being taken here.

But I certainly support it and would hope we would embrace it as a step forward to be more efficient and effective at what we do in conducting the audits of internal control.

MS. VIRAG: Randy Feltchall?

MR. FLETCHALL: To that point, Arnie, I thought Ed said it very well, in terms of describing the difference between the preparer and auditor. I think the proposed changes, proposed standard to replace AS-2 does as said remove -- if there were barriers before, if there was a mindset one had of using the works of an internal qualified audit department, I applaud those changes. It is good to get rid of anything like that.

Where there is confusion, though, in the new proposed standard on using the work of others, this seeking out relevant activities of management would suggest there's something there besides the competence and objectivity and controls they have in place to prepare financial statements, and suggests there's something else out there.

Again we're chasing this Holy Grail. You would have considered those other things in making risk assessments to start with. I think it is promising there's something more there that we could take and use. Now in a bank situation you might have something -- you might have a credit review department.

But I think it promises maybe there's something else out there that management is doing that would constitute ^ designation alter ^ audit evidence, and I think as we look -- we are having trouble finding where that would be. That's where we are comfortable with the existing standard on using the work of others but the changes to AS-2 that remove any barriers that might have been in existence with respect to internal control.

MS. VIRAG: Unless there's more comments, I think this will wrap up the subject; and actually all of the five topics we have selected for discussion. Thank you. Do you want to slip one in on this topic? Joe Kellas?

MR. KELLAS: I was sort of waiting for the discussion on barriers to be ended and then take the final question. I'm not sure if you're wrapping up the barriers.

MS. VIRAG: I was going to wrap it all up. I thought we got through both of those. We would love to hear from you.

MR. KELLAS: One point on integration, maybe this is why not much has been said on it. It is not easy to answer on the back of the proposed draft because it depends on what is in the other standards in relation to risk assessment and so on.

When I read the draft standard, I noticed references to risk of material weaknesses; and so the language of risk assessment has been transplanted from assessing the risk of material misstatement to assessing the risk of material weakness.

Now, in simple terms, a material weakness is a state of affairs where the risk of material misstatement is too high to be acceptable.

So you now are talking about risks of a risk. And I just wondered how that integrates with what you have on the other side of the audit about risk assessments?

So that's where I would ask myself: Is there a true integration of the two standards; and is it a complication to be starting to talk about risks of material weakness as opposed to risks of material misstatement?

MS. VIRAG: Okay. At this time I would like to open it up for any other discussion points on auditing or on the proposals, analysis. We didn't scope the subjects, but if you have other comments you would like to make at this time please feel free.

Rebecca McEnally?

MS. McENALLY: Thank you. Just s very brief and a very general comment. A small proposal to think about here.

The discussion today has been quite interesting. I think it has been very helpful in identifying potential confusions, areas where
misunderstanding could occur, with resulting audits
that are less than we'd like them to be, and also
difficulties in auditors working with managers at
companies.

But I want to raise something slightly
different. Lynn Turner raised an issue that I think
characterizes a lot of issues in this particular
area.

The audit of internal controls has been
around forever. When I was teaching auditing decades
ago -- not quite that long -- it was an issue. It
was in the text. It was something we taught. Yet in
practice, somehow, it was not at the top of the list
in most audits.

What Lynn was really saying, I think --
and he will correct me if I'm wrong -- is that in the
area, for example, of top-down, risk-based audits of
controls, we haven't made all the progress we would
like. We've been doing it for 20 years, but we're
still seeing problems.

Perhaps -- and I hope it is certainly true
-- we are seeing fewer problems than we would have
seen six years ago. I do fervently believe that.
But there are still problems.

I see this as an opportunity for us. The
opportunity I see is that the PCAOB in its normal
day-to-day operations and functioning has a vast
amount of data. It has a lot of insight into what is
going on in the audits; and it has an opportunity to
move beyond the analyses that it is currently tasked
with doing.

I would like to see these analyses where
there are serious problems emerging, serious
failures, certainly serious failures, but other
problems as well, carried beyond the point of whether
an auditor failed to pick up on a problem in revenue
reporting, and whether that got corrected promptly
and whether that problem appeared later.

I would rather see that, in addition to
that, the whole process gets carried one more level,
one more step.

Why did the auditor fail to pick up?
Was -- and I -- at this point we get into touchy
territory. I'll say a couple of words; you please
fill in some more silently, please.

Was it a matter of competence? Was it a
matter of experience? Were the incentives all wrong?
Just exactly what was going wrong here?

Because until we approach that problem --
which is really basically an issue -- we're not going
to know what we need to do to ultimately improve our
standards and to make certain these things aren't
happening, or at least to provide as much assurance
as we can. We can't get to zero.

You have within the PCAOB I think the
capability to do it; but it's my understanding that
it's not going quite that fast.

Let me be quick to say before anybody gets
excited here, I wouldn't -- I know what's going
through the minds -- I would not want to see this as
part of a criminal or civil proceeding. That's not
the proper place. What we want is a learning process
and, therefore, a revision to the work that we're
doing, an improvement of the process and not
primarily a fault-finding process.

So I would encourage the -- those in a

position of authority to give some consideration to
it.

Thank you.

MS. VIRAG: Cindy Richson?

MS. RICHSON: I have a question that is a
follow-up to what several SAG meetings ago where the
topic of limitation of liability provisions for
auditors was discussed. This is actually a question
I would like John White or Conrad Hewitt to address
if they wouldn't mind.

I have heard and seen press accounts and
references to speeches that the SEC was considering
incorporating limitation of liability limitations
into AS-2. I wonder if that's true. I would like to
say for the record if that is true, which I hope it
is not, that would be a significant detriment to the
investing public and would significantly take away
very important checks and balance in our existing
system.

MR. HEWITT: Thank you for the question.

I believe the SEC probably will not have anything
like you described in the past. The SEC does
exercise safe harbors in some of their rules such as
the designated financial expert, which I was for
three public companies. I was glad to see the safe
harbor, as a person, that my liability would not
exceed that of any other board member. I think
that's the type of thing that should be exercised by
the SEC.

We don't have any other plans to do things
like that in AS-5.

MS. VIRAG: Jeff Carcello?

MR. CARCELLO: These are from the auditing
standards committee of the auditing section of the
IAAA. They forwarded me their comment letter and
asked me to consider if there's anything I want to
incorporate into my written comments.

One deals with a change in consideration
of weaknesses; and the AS-2 had language "more than
remote" and now the language has changed in the new
standard to "reasonable possibility."

And the board may want to consider --
there is actually research on this -- as to how
auditors operationalize these terms. And you may
want to go back and look at a 1994 paper by Amir
Hackenback and Mark Nelson. And the median
probability that audit managers use for the term
"remote" is 10 percent and the median probability
that audit managers use for the term "reasonable
possibility" is 60 percent.

That's a really big difference. Is that,
in fact, what the board really wants to put in place
if, in fact, audit managers are operationalizing it
in that manner?

Now, they don't have to. One of the
questions you might want to think about is, is iteally appropriate to use the FAS 5 framework in the
standard?

I know the first SAG meeting I came to I
referenced that framework. I think somebody had a
comment, something to the effect that it was garbage.
And so you might want to think about whether, in
fact, that's appropriate.

The second comment relates to a strong
indicator of a material weakness being a lack of an
independent audit committee. And you make it very
clear in the exposure draft that pertains to
companies where the listing standards would require
an independent audit committee.

The question then I guess is even if
you're not required to have an independent audit
committee, the COSO framework when it talks about
control environment, which is typically the framework
that's going to be used, strongly emphasizes an
independent board, an independent audit committee as
a major feature of a control environment that's
effective.

And maybe more importantly than that even,
there's extensive research that finds an overwhelming
direct relationship between independent directors and
a lower incidence of both fraud and misstatements. I
refer you to work by Patty LaChow in 1996, Mark

MS. VIRAG: Damon Silvers?

MR. SILVERS: You know, to Cindy Richson's
question and ^ Con's response, I want to add
something that is very important here.

Everybody knows and it is appropriate that
the SEC and the PCAOB interact a great deal on the
issues that they mutually face. And that that occurs
at the staff level, that occurs at the board level.
That's fit and proper and healthy.

However, there is, I think, a constant
danger given just the way the Sarbanes-Oxley Act is
structured and the formal relationships that exist
between the commission and board, there's a constant
danger of inadvertently people at the Commission
saying or doing things that might be perceived as
undermining the autonomy and independence of the
PCAOB.

I think from the investing public's
perspective, this is exactly what we don't want to
see. It doesn't do anyone any good when that
happens. And it is not a question necessarily even
of the reality but of the perception, what people
hear, what people say.

I have been in public quite supportive of
the outcomes that have occurred in the 404 area from
both the PCAOB and the Commission as a general
matter. And I hope that -- and I say that to sort of
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<td>1 emphasize the respect I have for the Commission on many levels -- but I would give some advice to the folks from the Commission who are here which is keep in mind how important it is to reinforce the independence of this body here and how much responsibility rests on the Commission and its staff in relation to doing that, given the way the two institutions are structured and linked.</td>
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<td>1 restatements coming through; and each one of those have very serious consequences from a governance perspective.</td>
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<td>MR. TURNER: A broader overarching issue not only with internal control but the fraud stuff we'll get into later on, does back and begs the question of, given what we're asking people to do in this top down risk-based area -- especially without additional guidance on certain procedures that people should be looking at doing, as Craig mentioned earlier -- is ultimately the question of do you have people doing the work that are capable of doing it and competent to do it? And when you talk about making these risk assessments, you're talking about risk assessments that usually people with the type of experience that</td>
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<td>1 How would you go in, for example, if you -- the recent court case on Tyson -- here's Tyson, a company that their board broke an agreement with the Delaware court they earlier entered into; they spring-loaded options, which the court has now said is inappropriate and raises the currently emerging issue for auditors given that current decision on spring-loading.</td>
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<td>12 How could you even depend upon that board? Given that, how could you even do an audit at Tyson given that a number of those board members are still sitting there at the top?</td>
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<td>16 And certainly those are all valid questions that have popped up in many of these major frauds. Yet this standard I don't think asks those tough questions and gives a response to them.</td>
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<td>20 I think it is something you seriously have to consider: How do we get from where we are at to where we need to be on these?</td>
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<th>Page 175</th>
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<td>1 are sitting around the table here are used to making. Yet we know, 80 percent of the hours are still being spent by people with zero to five, zero to six years of experience. So while they're very sharp and bright and talented people, there's no way that they have the ability to turn around and go do those risk assessments. I think you have to think about do you put something in here about the fact that these risk assessments have to be done at the partner level, because they just can't be done by the people down below. They don't have the experience. And history has shown us that we're missing them. I still get back to, even notwithstanding that they are going to pick up on them, we now have an option scandal out there that's consumed well in excess of 200 companies, and there's probably many more out there that probably haven't disclosed it yet. Yet the auditors didn't pick up on that at all; and I suspect that it's because in part, whoever did make the risk assessment on those audits assessed the risk low. Yet we've seen some very, very significant</td>
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<td>1 MS. VIRAG: I think with that we'll conclude our discussion today on the board's internal control proposals.</td>
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<td>12 Is there one more? I beg your pardon.</td>
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<td>16 MR. BECKER: To pick up on Lynn's point a little bit. This standard -- it strikes me -- places a huge premium on the capacity of the auditor, whoever that happens to be, for risk assessment; and I agree with Lynn's point that it does make a difference as to who is assessing the risk. I also think, though, that there needs to be built into this safeguards with respect to the unapprehended risk, because it's the nature of humans that there's not just not going to be -- able to apprehend all the risks.</td>
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<td>16 I worry a little bit that there is too much faith in the capacity of auditors to identify, both at the outset and as an audit develops, all the relevant risks, because we all get surprised. And we get surprised with sort of startling frequency.</td>
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<td>21 What this standard seems to be, more than anything else, is all the things that auditors don't</td>
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have to do compared with AS-2; and I just think it's
important to address the issue of the limits of
people's capacity to assess risk at the outset and
then what procedures are built into the audit as a
result.

MS. VIRAG: Thank you. For the record,
that was David Becker speaking.
At this time I'm going to pause longer to
see if anyone else would like to make another
thought?
Dick Dietrich?
MR. DIETRICHS: I would like to reinforce
and amplify perhaps David's comments. There has been
research done trying to see how well calibrated
individuals are in assessing risk.
Some of the experiments go along the
following way: Take an event that's going to occur
two weeks ahead, for example. What do you think the
high temperature is going to be two weeks from now?
Don't tell me the number. Tell me a range where you
think nine out of 10 times you'll be within that
number.

And it turns out that we horribly
mis-estimate that tolerance.
So we might say 90 percent of the time the
actual number is going to be within this range, and
it turns out to be 60 percent of the time. It gets
to this point of risk assessment.
And it turns out that that doesn't -- that
does extend also to people with expertise. It takes
a tremendous amount of expertise -- I think, to
Lynn's point, it takes a considerable amount of
experience in estimating risk probabilities here.

MS. VIRAG: Okay. So that concludes our
discussion on the board's internal control proposals.
We appreciate everybody's participation.
I think that was extremely helpful for us. A lot of
great comments. We really appreciate that.
As we mentioned in our briefing paper, the
transcript of this part of the meeting will be
included in the public comment file.
Having said that, we also encourage all of
the SAG members, anyone in the audience or tuned in
to the webcast to submit comment letters to the board