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C O N T E N T S

P R O C E E D I N G S

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

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

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

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

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

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

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

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

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

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

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

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

So, Chairman Olson, welcome.

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

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

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

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

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

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

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

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

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

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

In response to our proposal in December, we received over 170 comment letters totaling some 1200 pages of comments. These comments reflect a broad range of views. In general they articulate considerable support for the proposals as well as many helpful suggestions. Since the first comments came in, our staff has been reviewing, compiling and analyzing these comments. Indeed, my colleagues and I on the Board have spent many hours reading and thinking about the comments.

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

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

As with the Commission's process the PCAOB brings the perspective of its five Board members to bear in deliberating on and eventually voting on final board standards. I can assure you, however, that we are open to and are carefully considering all comments we have received and that we are committed to adopting a standard that fulfills the mandate of Section 404 without resulting in the performance of unnecessary audit procedures.

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

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

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

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

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

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

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

The auditor's perspective, however, is quite different. Like the financial statement audit, the audit of internal controls is intended to provide investors with an independent accountant's opinion formed on the basis of procedures performed with appropriate professional skepticism about whether the internal control is effective. The standard must therefore establish a process through which an independent auditor can form a sufficient basis for expressing such an opinion.

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

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

While there was a close relationship between management's and the auditor's work, this does not mean that the audit should not consist of any different or additional procedures other than what management has already performed as part of its assessment.

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

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

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

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

Many commenters stated emphatically that this should not be a stand-alone discussion that applies only to smaller companies. Most commenters felt strongly that all audits should be tailored based on the complexity of the company even though the benefits of scaling are likely to be of great benefit to smaller companies.

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

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

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

Accordingly the proposals provide a framework that is designed to enable the auditor to obtain the reasonable assurance necessary to support his or her opinion.

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

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

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

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

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

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

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

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

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

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

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

CHAIRMAN COX: Thank you very much.

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

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

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

Mr. Steinhoff, welcome.

MR. STEINHOFF: Thank you so much. Chairman Cox, members of the Commission, I am pleased to be here today to discuss the Commission's proposed guidance for Section 404 of the Sarbanes-Oxley Act and the PCAOB's proposed revisions to Auditing Standard No. 2.

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

Investor protection is the heart of what we are speaking about today and my remarks that follow will address not only smaller companies, but all companies because we think the manner in which Auditing Standard No. 2

was applied added burdens to all companies.

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

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

We urged use of a top-down risk-based approach when the current Auditing Standard No. 2 was first considered and continue to strongly believe that this approach, if done properly -- and I emphasize done properly -- can maximize efficiency and effectiveness in the assessment of internal control. Such an approach provides needed flexibility for both management and auditors to make informed decisions based on relative risk and cost benefit considerations versus having overly prescriptive “one-size-fits-all” requirements.

As the Commission and the PCAOB move in this direction, the challenge will shift to the need to properly implement this approach and to hold company management and its auditors accountable for doing so. Effective implementation of a top-down risk-based approach requires the involvement of highly knowledgeable senior management and audit professionals in order to make sound judgments about the risk of material financial statement misstatement. Reaching the proper balance is challenging but very achievable if the assessment is approached with a goal of protecting the investor and with the right amount of expertise and professional skepticism going in.

If a top-down risk-based approach is not properly implemented by company management and/or the auditors, its effectiveness can be compromised. Therefore, if the proposed changes are adopted, it will be critical that the Commission and the PCAOB closely monitor implementation. In the case of the PCAOB, it can use its inspection program to monitor auditor implementation. Again, we're very supportive of a risk based approach. We think it can be effective and efficient, but it must be done in a proper manner.

Second, the SEC and the PCAOB should continue to emphasize management and auditor responsibilities related to fraud. Management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity. The auditors' responsibility for detecting and reporting fraud overlaps with their responsibility for reporting on internal control over financial reporting under Section 404 since effective internal control generally serves as the first line of defense in preventing and detecting fraud. These things are intertwined.

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

Third, coordination among regulators and standard setters is very important. Continued coordination such as today between the Commission and the PCAOB will be needed to monitor implementation of Section 404 and to identify any additional ways for achieving economical, effective and efficient implementation.

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

Also important is the need for the PCAOB to continue to coordinate with other U.S. audit standard setters––GAO and the AICPA––and with international standard setters on key issues, such as the terminology and definitions used to communicate internal control deficiencies. At this time, all the U.S. auditing standard setters are in sync and have adopted consistent definitions of a material weakness and a significant deficiency. Everyone will be best served by having standard setters develop consistent core auditing standards and, where there are any differences, to articulate why there is a difference or a need in the particular environment we're in.

Inconsistencies in core standards can increase audit costs and lead to potential confusion among management, users and auditors. In this context, the U.S. auditing standard setters meet roughly three times a year collectively. We had a meeting a couple of weeks ago which David Walker hosted at the GAO and we're very appreciative of the very open environment that the PCAOB has fostered.

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

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

It will be very important that the Commission and the PCAOB continue to reinforce the over-arching goal of investor protection, as well as the principles I have just highlighted in order to achieve sensible, effective, and responsible implementation of Section 404 and to ensure that investors never again suffer from another Enron or a WorldCom.

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

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

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

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

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

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

Chairman Cox and members of the Commission, the increased focus on companies' internal controls over financial reporting, commonly known as ICFR, under Section 404 of the Sarbanes-Oxley Act in the Commission rules has improved investors' confidence in our financial markets. Overall, the public disclosures relating to ICFR have led many issuers to establish and maintain more effective internal controls which has resulted in financial reports that are more reliable and transparent.

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

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

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

MR. WHITE: Thank you, Conrad.

And good morning. Chairman Cox, you mentioned and actually the Commission's press release announcing today's meeting also specifically noted that we are here today to discuss the PCAOB's proposed new auditing standard under 404, of course, but also in particular you noted and the press release noted that we are here to discuss its coordination with the Commission's proposed Management Guidance.

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

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

And I believe, as all of us can see, those May 17 press releases were really important in previewing most of the things that have actually happened in the last year in the 404 arena. Of the Commission's four steps which were laid out, the first was the Management Guidance which I have described and the second was revisions to Auditing Standard 2. The third was the SEC’s oversight of the PCAOB inspection process which was designed last year to focus on the efficiency of Section 404 implementation and the fourth step was the extension of the compliance deadlines for non-accelerated filers which was finalized in December.

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

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

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

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

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

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

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

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

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

So that's it on my comments. I’d also, like to mention to my right is Carol Stacey who is the Chief Accountant in the Division of Corporation Finance and one of the key participants in this project.

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

MR. HEWITT: Thank you, John.

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

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

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

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

To emphasize this point, a number of commentaries sent the same letter to both the SEC and the PCAOB. For example, commentaries believe that the differences between the two proposals and the degree of detailed rules versus objective-based guidance and the amount of professional judgment each approach permits may make the auditing standard and management guidance more difficult and costly to implement.

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

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

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

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

MS. PALMROSE: Thank you, Conrad.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Moreover, the PCAOB's Auditing Standard Number 3 provides audit documentation requirements that when combined with the musts and shoulds could have a significant impact on the level of audit effort.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CHAIRMAN COX: On the second topic on definitions, I think I can understand as a general matter why we don't want to confuse everyone, why we don’t want to have one definition in place in the PCAOB standard and use the same term with a different meaning as part of the same process in our Management Guidance. But can you give me an example of why this is difficult?

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

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

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

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

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

And I think Jeff Steinhoff from the GAO sensitized us to the importance of this for everybody. In other words, it is important to have terminology that is converged and consistent and harmonized across auditing in all sectors. And so we very much appreciate that for users across all markets.

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

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

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

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

MS. STACEY: I think we will have the definitions, obviously, either in Management Guidance or if we believe they need to be elevated to the rule level, we will propose that. So we have yet to work through that between ourselves and the PCAOB, but that is a focus area of ours.

CHAIRMAN COX: All right. Commissioner Atkins.

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

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

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

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

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

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

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

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

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

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

MS. PALMROSE: Exactly.

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

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

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

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

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

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

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

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

CHAIRMAN COX: Commissioner Campos.

COMMISSIONER CAMPOS: Thank you.

Let me add quickly my appreciation to the staff here at the SEC for all the efforts that have been put forth so far to bring us to this particular point and in particular the willingness to work with the PCAOB, their staff and, of course, the Board and the leadership there in terms of our two agencies working together. And I think to this point being very committed jointly to get and to resolve a very challenging regulatory dilemma which is to essentially have investor protection with a reasonable and rational cost in particular for the small issuers.

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

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

Zoe-Vonna, how would you answer that concern?

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

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

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

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

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

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

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

MS. PALMROSE: No, not at all. In fact, that's what we are constantly thinking about. And, as I said just to reinforce, we believe, we firmly believe that investors in all companies are entitled to these disclosures and that this is doable and that's what we are working to achieve.

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

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

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

COMMISSIONER CAMPOS: I thought he was witty, too.

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

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

MS. PALMROSE: We're auditors here.

COMMISSIONER CAMPOS: But are you using judgment?

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

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

How do you square that in terms of that debate?

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

You have to be able to allow auditors and management to make judgments about the risks within their own organizations and the auditor to bring to the table evidence from that risk assessment, from management's process as well as from the financial statement audit in an integrated audit sense. And it's not possible to anticipate all of those facts and circumstances and prescribe responses to them.

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

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

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

Essentially, we have a process in place now with the PCAOB in which we can, the PCAOB can assess the role of standards in any of those failures. But largely the analysis of those failures have been one of performance not standards.

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

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

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

CHAIRMAN COX: Thank you. Commissioner Nazareth?

COMMISSIONER NAZARETH: Thank you very much. I'm very heartened by the conversation today because I think it really evidences that our goals are very significantly aligned between the SEC and the PCAOB. I mean our focus is on investor protection and on integrity of internal controls. Our focus seems to be on a top-down risk-based approach to the audits. And certainly it's on effectiveness and efficiency of implementation of Section 404.

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

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

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

MS. PALMROSE: Well, I think Carol can jump in here again. I think there are slight differences in some areas between our definitions that I suspect are not going to be impediments at all. We have a slightly different one.

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

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

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

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

MS. PALMROSE: Oh, yes. Yes.

COMMISSIONER NAZARETH: That would be the whole game.

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

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

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

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

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

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

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

COMMISSIONER NAZARETH: Who is witty.

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

COMMISSIONER NAZARETH: The pressure is on.

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

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

But in any event, in response to your question about whether the staff believes that management's evaluation process and the auditor's approach should be identical, and the answer to that is no. We don't believe that the processes should necessarily be identical.

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

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

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

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

COMMISSIONER NAZARETH: Thank you.

CHAIRMAN COX: Commissioner Casey?

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

As a follow-on to the question that was just asked, inasmuch as our Management Guidance hopes to provide sort of workable guidance to issuers as well as acceptable frame works that are flexible to address particular characteristics of smaller companies in particular. As you work through some of the alignment issues with the PCAOB, in light of the Chairman's comment that they do have different functions or different purposes, how important will that be? I guess I'm asking will that be important to our achieving the benefits of Management Guidance if we are not able to leverage off of the benefits that we would anticipate coming from that flexibility?

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

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

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

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

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

MS. PALMROSE: I just wanted to add, too. We do have some comment letters that are very helpful, too, in terms of making suggestions. And we're in the process of analyzing those and hopefully we will be able to incorporate those, too.

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

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

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

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

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

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

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

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

MR. HEWITT: I just might add on this point that the implementation of the standard will be very, very important assuming we have an excellent Standard AS5. The PCAOB will have to train their staff extensively into the new standard before they're out in the field inspecting the external auditing firms. And that behavior will have some effect on whether or not the standard is effectively implemented.

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

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

COMMISSIONER CASEY: Thank you very much.

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

(No response.)

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

Specifically on alignment, the SEC staff proposes to work with the PCAOB staff (1) to identify and eliminate any unnecessarily prescriptive requirements where the overall principle or objective has been well stated and (2) to harmonize the key terms and definitions in the Commission's Management Guidance and Rules and the PCAOB's definitions in its two proposed auditing standards.

Do the Commissioners support the staff's approach?

COMMISSIONER ATKINS: Aye.

COMMISSIONER CAMPOS: Yes.

COMMISSIONER NAZARETH: Yes.

COMMISSIONER CASEY: Yes.

CHAIRMAN COX: Yes.

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

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

MS. PALMROSE: Thank you. Let me just start us off. The next issue is, as the Chairman said, we would like to discuss relates to the section in the PCAOB's proposed audit standard entitled, "Scaling the Audit."

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

Nancy?

MS. SALISBURY: Thank you. The PCAOB received a number of comment letters in response to the section in AS5 on scaling the audit that raised concerns with the staff that the guidance may not have been understood as intended.

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

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

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

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

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

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

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

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

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

And, thank you, we'd be happy to take any of your questions at this time.

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

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

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

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

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

CHAIRMAN COX: Zoe-Vonna?

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

CHAIRMAN COX: This leads us into another topic.

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

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

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

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

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

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

CHAIRMAN COX: All right. Commissioner Atkins?

COMMISSIONER ATKINS: Thank you, Mr. Chairman.

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

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

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

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

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

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

COMMISSIONER ATKINS: Right.

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

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

MS. PALMROSE: I can start off and others can join in but I think the first step is reconsidering the musts and the shoulds within the standard. So that will help so challenging as Mark Olson said that the PCAOB staff is doing, challenging those is going to be an important consideration because again remember that documentation sort of changes your focus from the substance to the form of it. And it should really instead cause you to think more rigorously and deeply, not simply do it to document that you have done it.

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

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

COMMISSIONER ATKINS: Okay.

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

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

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

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

CHAIRMAN COX: Commissioner Campos.

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

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

MS. SALISBURY: To us scaling is not trying to have a different standard for different companies. It's more about allowing an auditor to be able to recognize that there are different facts and circumstances at each particular company and that you aren't going to be able to use a one approach fits all when you are trying to evaluate the effectiveness of internal control.

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

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

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

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

COMMISSIONER CAMPOS: Well, again, these terms are out there in the world and I think it's incumbent on us and the staff to be very clear about what we mean and to protect against misinterpretations of this term as well as our earlier discussion about judgment.

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

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

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

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

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

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

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

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

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

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

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

COMMISSIONER CAMPOS: And be small.

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

MS. STACEY: And I agree with Zoe-Vonna. I mean size is just one of the indicators of how you're scoping your audit. The Advisory Committee on Smaller Public Companies pointed out that, you know, smaller companies tend to have less complex systems. They tend to be simpler with financial reporting. But there are also some that we have seen that are much larger. They have large market caps but they have a very simple business model. And so for that instance, size really doesn't matter because they are very similar to some of these smaller companies. So, while size is a very important indicator, there are others and complexity can be one of them. But there are also companies who are very simple except they have one very complex transaction and that doesn't necessarily make them complex. So it is one of the indicators, but there are several others.

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

CHAIRMAN COX: Commissioner Nazareth.

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

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

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

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

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

MS. STACEY: Absolutely.

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

COMMISSIONER NAZARETH: Thank you.

CHAIRMAN COX: Commissioner Casey?

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

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

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

Brian, do you --

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

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

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

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

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

(No response.)

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

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

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

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

Do the Commissioners support the staff's approach?

COMMISSIONER ATKINS: Aye.

COMMISSIONER CAMPOS: Yes.

COMMISSIONER NAZARETH: Yes.

COMMISSIONER CASEY: Yes.

CHAIRMAN COX: Yes.

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

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

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

MR. CROTEAU: Thank you, Zoe-Vonna.

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

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

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

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

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

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

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

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

We have heard feedback that this communication responsibility may be inappropriately affecting the level of audit scoping.

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

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

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

The Commission staff proposes to work with the PCAOB staff on the following three suggestions. First, to ensure that the auditor has latitude to establish the level of evidence required based on the auditor's assessment of risk.

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

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

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

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

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

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

CHAIRMAN COX: Is that another way of saying we know what we're talking about but the people who are reading it don't seem to understand it?

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

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

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

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

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

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

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

MR. HEWITT: I just might add, the risk assessment by the auditor is extremely important as to their scope of their audit. However, they must or should discuss their risk assessment with the audit committee so that the audit committee understands what the auditor considers as risk, high risk especially within the company.

CHAIRMAN COX: Thank you for that.

Brian, do you have anything else?

MR. CROTEAU: No.

CHAIRMAN COX: Okay. Commissioner Atkins?

COMMISSIONER ATKINS: Thanks, Mr. Chairman.

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

I guess my question for you is how would your recommended approach help to direct the auditors' identification or their work more towards identification of material weaknesses than to significant deficiencies. And just by this very fact of this nomenclature that's new to this whole 404 regime, significant deficiency, we sort of come in a way full circle from the concept in AS2 now to more judgment which is much more of the old reportable condition concept. Shouldn't we just do away with significant deficiency and focus on having the accountants report reportable conditions to the board, to the board of directors, to the audit committee as they have been want to do for many, many years rather than having this, this sort of artificial determination that goes up to the national office and then back and there's all this incredible amount of work and added expense which adds to the -- it is in the pecuniary interests of the auditors perhaps but not perhaps the investors' interests.

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

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

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

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

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

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

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

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

We are not suggesting that that be changed.

COMMISSIONER ATKINS: Right.

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

COMMISSIONER ATKINS: Right.

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

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

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

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

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

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

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

CHAIRMAN COX: Commissioner Campos.

COMMISSIONER CAMPOS: Thank you.

In theory, the idea of allowing auditors to vary the level of testing according to the risk assessments seems very logical and rational. That said, I am aware that there is skepticism or concern in various quarters that when done in total this process of using reduced or at least the flexibility to have reduced testing will lead to gaps in testing with respect to individual controls or groups of controls.

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

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

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

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

Some also view rotation to be rotating out some portions of ICFR in some years so that they are not testing some controls at all or considering those controls at all in a given year. The staff does not support incorporating rotational testing in the standard in that sense.

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

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

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

In terms of your broader comment on the totality of all of these considerations, the auditor still needs to obtain sufficient competent evidence and be able to issue an opinion that provides reasonable assurance. And so we are not asking the auditor to take things off the table that prevent them from doing that.

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

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

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

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

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

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

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

MR. CROTEAU: Yes.

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

MR. CROTEAU: Yes, the auditor has to have sufficient competent evidence to support their opinion, yes.

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

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

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

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

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

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

COMMISSIONER CAMPOS: Good. I'm almost done.

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

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

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

Having said that, one of the things that Jeff alluded to but we haven't talked at all about is when it comes to fraudulent financial reporting is the risk of management override in particular.

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

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

COMMISSIONER CAMPOS: So somebody will see that elephant.

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

COMMISSIONER CAMPOS: Sure.

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

COMMISSIONER CAMPOS: Thank you very much.

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

Commissioner Nazareth.

COMMISSIONER NAZARETH: Thank you.

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

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

So could you again, because I'm not sure I completely understood your answer, could you again describe how the current accounting literature works and what we would do to the current literature to ensure that we get both the benefits of, you know, not having the scope of these audits expand unnecessarily but at the same time having a robust dialogue with audit committees on these important issues?

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

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

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

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

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

So within that context it has caused us -- in some of the comment letters, there's not I don't think a large number on this. I think it's a fairly small number, but it has caused us to sort of rethink this area. And that's what Carol was alluding to here in terms of the existing requirement outside of AS5 for communications on these. And the question is does it have to be within the context of AS5.

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

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

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

COMMISSIONER NAZARETH: Right. And I think that makes sense. I guess the other concern that some might raise that we need to be conscious of is whether or not if through this process we end up having the auditors only communicate the information to management ensuring that there's no break between management and the audit committee in having that communication occur. I think that certainly some commentators will say, "Well, at least this way you knew that it was going to happen because the auditor was going to do it."

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

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

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

And so I think -- we think that this approach eliminates that bright line test, is it a significant deficiency or not, eliminates the potential scuffles back and forth between management and the auditor over what is and is not on the list. Potentially eliminates the scoping issues but still leaves the auditor with the professional responsibility to discuss with the audit committee any deficiencies that concern them that they believe the audit committee should be aware of.

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

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

COMMISSIONER NAZARETH: Thank you.

CHAIRMAN COX: Commissioner Casey.

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

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

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

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

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

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

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

COMMISSIONER CASEY: And I know there has been a lot of discussion about the rationalizing of the use of significant deficiency and enhancing the communication to the audit committee and the responsibilities that management has to report significant deficiencies under the law, so I appreciate that clarification of what our efforts would be in discussing this with the PCAOB and enhancing ways to ensure that management does continue to fulfill their obligations.

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

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

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

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

So we are having dialogue around those and the importance of those within the guidance itself. So that's part of the dialogue that we would like to have. We appreciate that whatever guidance is there would need to be similar now that we obviously got that message that they do need to be similar. But we are revisiting the whole area in terms of the necessity of them and what they say. And, again, the comment letters are helping us inform that.

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

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

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

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

COMMISSIONER CASEY: Thank you.

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

(No response.)

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

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

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

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

Do the Commissioners support the staff's approach?

COMMISSIONER ATKINS: Aye.

COMMISSIONER CAMPOS: Yes.

COMMISSIONER NAZARETH: Yes.

COMMISSIONER CASEY: Yes.

CHAIRMAN COX: Yes.

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

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

MR. JONES: Thanks, Zoe-Vonna.

As background, the PCAOB's interim auditing standards cover the ability of the auditor to use the work of internal auditors for the purposes of the audited financial statements. While Audit Standard Number 2 allows auditors to use the work of internal auditors, other company personnel and third parties working under the direction of management in the audit of internal control, the PCAOB proposed a new audit standard, Considering and Using the Work of Others, in order to provide a single framework for the auditor's use of the work of others in an integrated audit of internal control and the financial statements.

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

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

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

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

Commenters also raised concerns regarding the restrictions on the auditor's use of management's monitoring activities because in their view it was unlikely that management would ever be deemed objective in accordance with the factors outlined in the proposed auditing standard.

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

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

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

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

If appropriately designed and operated, monitoring activities might also be a useful source of evidence for auditors and should not be excluded simply because by their very definition the individual performing the monitoring activities is not independent of the underlying control activities.

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

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

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

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

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

MR. JONES: One of the reasons that the staff feels there needed to be changes is that the internal control over financial reporting has fostered the ability of many people within the organization who don't exactly have an audit background or have an internal auditor-like background in their job requirements to perform activities that are or could be very relevant to the assessment of ICFR.

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

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

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

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

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

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

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

CHAIRMAN COX: Thank you.

MS. STACEY: Yes. And some of the comment letters went back to the number of factors that the auditor has to consider when determining objectivity and independence or competence and objectivity.

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

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

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

And there is also a prescriptive ordering here in terms of assessing competence and objectivity and then relevant activities and the firms suggested that it would be more effective and efficient to reverse that ordering.

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

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

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

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

It could be interpreted under the standard today as proposed that the auditor, the external auditor would have to examine my personnel file to see if I was qualified, and could I count 1 plus 1 and this type of thing. And we don't need that type of thing in today's standard or auditing world. So that is the type of thing that we want to avoid. From a practical viewpoint, the use of management in the internal control audits and testing probably is on a very seldom basis.

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

CHAIRMAN COX: All right. Thank you.

Commissioner Atkins.

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

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

The GAO did a study where of the 150 companies that they surveyed, 128 actually hired another accounting or consulting firm to help them on Section 404 and for the most part, the accounting firms felt they couldn't use any of that work in their procedures.

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

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

COMMISSIONER ATKINS: Well, I guess even more particularly with smaller public companies where if they have gone out and hired an outside consultant to help them on it, I guess one of the biggest tragedies I think from an investor's perspective, again, that company that I referred to earlier that paid more to outside consultants and its auditors than to put its 404 and financial statements together. Basically when I posed the question directly to the outside auditors whether they had even looked at this nicely put together internal control framework and documentation of the company, they basically said in all candor, "No, we didn't believe that we could under Audit Standard 2." Now, that company poured huge amounts of money into that whole process and for the outside auditors to feel like they could not even look at it even from a scoping perspective I think is a complete outrage from the investor's perspective since this is coming out of the investors pocket. So, I was just curious, how can we remove any unique obstacles with respect to smaller public companies?

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

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

COMMISSIONER ATKINS: Well, good. That's what I was hoping you would say because we've been addressing these four themes separately; but, just like anything else, the integration of 404 attestation into the financial audit I think is crucial. Part of the problem was that with AS2 and everything else it was taken off as a sort of a separate type of approach rather than an integrated approach. So, hopefully, you know, as we work with the PCAOB to try to get this back on track that we will keep that as our touchstone. Thank you very much.

CHAIRMAN COX: Commissioner Campos.

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

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

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

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

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

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

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

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

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

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

Now, this occurs again --

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

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

COMMISSIONER CAMPOS: I'll accept it.

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

COMMISSIONER CAMPOS: No, no. I can get used to it in a hurry. It's a good point in terms of the reliance. And it's probably something that isn't broadly understood either.

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

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

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

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

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

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

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

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

And so one of the things that we're trying to work through with the PCAOB is how to best articulate those principles so that it becomes a little more clear to auditors how they can take the work of management of the company and apply that to their decisions on what evidence they need to gather for the audit.

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

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

CHAIRMAN COX: Thank you.

Commissioner Nazareth.

COMMISSIONER NAZARETH: Thanks.

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

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

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

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

In terms of our position, the staff, right now just wants to discuss the merits of the firms’ proposal. But what is really important is that our recommendations are primarily focused around the considerations that are contained in both the interim standards and the PCAOB's proposals. And so ultimately the objectives we're trying to achieve can be accomplished through either way that the PCAOB determines is best to effectively communicate the audit standard.

COMMISSIONER NAZARETH: Okay, thank you.

CHAIRMAN COX: Thank you.

Commissioner Casey?

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

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

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

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

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

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

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

COMMISSIONER CASEY: Thank you very much.

CHAIRMAN COX: Thank you very much.

Is there any further discussion on this fourth aspect?

(No response.)

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

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

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

Do the Commissioners support the staff's approach?

COMMISSIONER ATKINS: Aye.

COMMISSIONER CAMPOS: Yes.

COMMISSIONER NAZARETH: Yes.

COMMISSIONER CASEY: Yes.

CHAIRMAN COX: Yes.

And that recommendation is agreed to.

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

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

So thank you very much for your effort and thanks very much to our Commissioners for the extraordinary amount of high-level involvement that we have had in this effort. I think it shows the country just how important the SEC believes that this is. I am confident we will stay on schedule and on track.

If there is no further business, the meeting is adjourned.

(The meeting was adjourned.)

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