

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on October 14, 2009 that related to the Board's proposed auditing standards related to the auditor's assessment of and response to risk. The other topics discussed during the October 14, 2009 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

(PCAOB)

STANDING ADVISORY GROUP MEETING

9:03 a.m.

Wednesday, October 14, 2009

National Association of Home Builders

1201 15th Street, N.W.

Washington, D.C.

14 MARTIN BAUMANN: All right. This afternoon,
 15 we're starting off with a topic I mentioned earlier,
 16 and that was an update on proposed standards and
 17 concept releases.
 18 There is the proposed standard on risk
 19 assessment that I mentioned a number of times and two
 20 concept releases, one on the use of confirmations and
 21 one of signing the audit report. And we'd like to give
 22 you an update. The comment periods have closed, but

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1 we'd like to give you an update on the comments we have
 2 received and then open it up for any commentary that
 3 you might have.
 4 The first item we're going to discuss is the
 5 proposed standard on risk assessment. And to my left,
 6 Keith Wilson will lead that discussion.
 7 KEITH WILSON: Thank you, Marty.
 8 Approximately a year ago at this time, the
 9 Board issued for comment, as Marty mentioned earlier, a
 10 suite of seven proposed auditing standards and related
 11 conforming amendments regarding the auditor's
 12 responsibilities for assessing and responding to risk
 13 in an audit. The comment period closed in February,
 14 and we received 33 comment letters.
 15 The demographics, as you see on the slide, 18
 16 or roughly 54 percent of those came from auditing firms
 17 and associations of accountants. The next group of
 18 commenters were academics and groups of academics,
 19 about 12 percent. And then there was roughly a mixture
 20 among issuers, business groups, internal auditors,
 21 investor representative, and some other standard
 22 setters and individuals.

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1 Now, what I want to try and do for these next
 2 couple slides is talk about just some of the general
 3 themes that came through in the comment letter process,
 4 and to do that and help set the stage for that, I'd
 5 like to back up and give you just a few minutes of
 6 background. When this proposal was issued, the Board
 7 outlined and identified a list of objectives that they
 8 wanted to try and accomplish through this project.
 9 The first one of those was to update the
 10 Board's standards relating to risk assessment to -- in
 11 light of the changes and the audit methodologies that
 12 are risk based that have been implemented and are
 13 prevalent in practice.
 14 The second one is to further the integration
 15 of the standards relating to risk assessment with the
 16 standard for the audit of an internal control over
 17 financial reporting, AS Number 5.
 18 And the third was to try to incorporate into
 19 these standards the general principles for identifying,
 20 assessing, and responding to the risk of material
 21 misstatement due to fraud that have existed in the
 22 Board's interim standard on fraud, but to make the

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1 fraud responsibilities a more central part of the risk
 2 assessment process.
 3 And as part of the development process for
 4 these standards, the Board did look carefully at the
 5 related risk assessment standards of the International
 6 Auditing and Assurance Standards Board, particularly
 7 looking at the objectives and the requirements of those
 8 standards and trying to determine whether they were
 9 appropriate for audits of issuers, which is our area of
 10 responsibility.
 11 So, as you can see now from this slide, we
 12 received a lot of comments in those -- in each of those
 13 areas. First of all, there was general support.
 14 Almost everyone who commented, in a comprehensive way
 15 at least, supported the idea of updating these
 16 standards to speak more directly to the risk-based
 17 audit.
 18 There was also pretty broad support for
 19 enhancing the integration of these risk assessment
 20 standards with the standard for internal control over
 21 financial reporting. And in fact, we received a number
 22 of comments that would seek to improve that integration

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<p>1 -- for example, trying to move more of the risk 2 assessment requirements into these standards out of 3 Auditing Standard Number 5.</p> <p>4 When it comes to the fraud-related aspects, 5 the views were a bit mixed. We had 15 people 6 specifically comment on the topic of integrating these 7 standards more closely with fraud, and 8 of the 15 were 8 supportive of the Board's approach. There were 4 who 9 were not as supportive of the Board's approach or 10 expressed some concerns about it, and then the 11 remaining 3 were somewhat neutral or ambivalent about 12 it.</p> <p>13 An example of that would be, yes, we could 14 see doing that, but our methodology already integrates 15 the consideration of fraud into our core methodology. 16 So we don't think it would have any effect on practice 17 one way or the other. So more of a neutral stance with 18 respect to that.</p> <p>19 Then in terms of perhaps more technical or 20 specific comments, we received a number of comments 21 related to the extent and nature of the requirements in 22 the standards, comments such as there were a comparison</p>	<p>1 proposed standards had a slightly different format from 2 some of the previously issued standards of the Board. 3 For example, there was a specific section that outlined 4 the objective of each of these proposed standards.</p> <p>5 And the commenters were supportive of having 6 an objective in each standard, certainly. They did 7 indicate some not necessarily reservations about the 8 format we used but, basically, came down to you need to 9 develop a standard template for your standards, a 10 standard style, and just implement that and follow it 11 from now on. So we received a fair number of comments 12 related to that.</p> <p>13 And then, finally, there was a comment -- 14 there were a series of comments about the effective 15 date of the standards. We hadn't specifically 16 mentioned or proposed an effective date for the 17 standards, and we received some -- a number of 18 comments, a lot of them were related to guidelines on 19 how the Board should determine its effective date for 20 the standards along the lines of please allow us enough 21 time to change our methodologies and to be able to have 22 enough time to train the staff and those kinds of</p>
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<p>1 of these standards to the IAASB standards or the ASB 2 standards, and they may observe that our proposal had 3 more requirements than the -- than a comparable IAASB 4 standard.</p> <p>5 There were also cases where they commented on 6 the specific language of a requirement. For example, 7 saying that we really needed to explicitly build into 8 the language of a requirement the -- qualify it based 9 on the auditor's use of professional judgment.</p> <p>10 There were a host of other comments related 11 to what I'll call the use of terms to describe the 12 auditor's responsibilities, and here, we're actually 13 talking about verbs. So we may have a requirement for 14 the auditor to "evaluate" or "assess" a matter, we've 15 received some comments that to use a different choice 16 of words, such as the auditor should "consider" a given 17 matter.</p> <p>18 So, and usually, those were, again, in 19 comparison to either the Board's interim standard or 20 the related standards of the IAASB or ASB.</p> <p>21 We received a number of comments about the 22 organization and style of these standards. These</p>	<p>1 things.</p> <p>2 And the important point that was also made by 3 a number of those commenters was that the Board should 4 propose a specific effective date and seek comment on 5 that prior to actually adopting the standards.</p> <p>6 So those are some of the most common 7 requirement -- some of the common comments that we 8 received on the standards. I'd be interested in any 9 reactions. We'll open this up for discussion, and 10 whether you have comments about these standards 11 themselves, maybe views that support some of the 12 comments we received, or other views?</p> <p>13 Does anyone have a reaction to the idea of 14 the approach for incorporating the general 15 responsibilities for fraud into these standards, any 16 comments one way or the other on that topic?</p> <p>17 MARTIN BAUMANN: Keith, I was interested in 18 that point, of course. And I wondered if others might 19 be -- as you said, there were kind of mixed views on 20 whether or not to embed fraud throughout the planning 21 and throughout the risk assessment process and 22 throughout the audit. But there were some, some who</p>

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1 view that as not a good idea, not neutral, but some
 2 were negative on that.
 3 Could you expand more on the ones who were
 4 negative on that?
 5 KEITH WILSON: I guess the way I would
 6 characterize the most -- most of those concerns were
 7 around the lines of they tended to prefer having a
 8 separate standard that was focused specifically on
 9 fraud. They thought it was helpful to have all of the
 10 auditor's responsibilities related to fraud summarized
 11 in one place and preferred that to the approach of
 12 incorporating the key aspects into the core standards
 13 for risk assessment.
 14 MALE VOICE: Keith, might I ask -- it's been
 15 some time since I've read these, and so when you ask do
 16 we have any comments, I wasn't really expecting it.
 17 What's the timetable now? Could we give you any
 18 comments by email on the specific standards? What's
 19 doable here? Because I feel like I'm maybe not quite
 20 as prepared as I could have been.
 21 KEITH WILSON: Well, actually, I think the
 22 comment period is closed, and we are in the process now

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1 of revising the proposed standards and putting them
 2 before the Board. I think I indicated earlier that our
 3 target was to issue proposed standards and revised --
 4 repropose these standards in December is our target.
 5 We wanted to present today generally in
 6 keeping with the theme of updating the SAG in terms of
 7 developments what was the nature of the comments we
 8 received. And as long as we were doing that, we just
 9 thought we would take the opportunity today, if anybody
 10 wanted to react to the comments we received or had
 11 something else to say, to do that.
 12 But other than that, I would say that
 13 essentially the comment period is closed. So, thank
 14 you.
 15 Damon Silvers?
 16 DAMON SILVERS: I mean, I spoke earlier today
 17 about the fraud standard, which I guess some of the
 18 commenters felt was a better place to address these
 19 issues than in the -- sort of in risk assessment and
 20 sort of throughout the standard, the bodies of the
 21 auditing standards.
 22 I mean, I think the Board ought to be wary of

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1 a catch-22 here, right? You know, there have been
 2 plenty of instances in Washington of people who don't
 3 want to do anything always pointing you somewhere else.
 4 Wherever you are, wherever you're actually acting, they
 5 will all go, "No, that's not the right place to act.
 6 Go over here." When you get over there, then they're,
 7 "Oh, no. That's not the right place. Now come back
 8 here."
 9 The Board should be wary of that kind of
 10 thing.
 11 My own view is, is that I think you need to
 12 do both. I think that there needs to be a clear,
 13 overarching set of obligations on auditors in relation
 14 to fraud, and then I think there needs to be an
 15 understanding -- and then those, that basic framework
 16 needs to be embedded in areas such as risk assessment,
 17 where it's clearly, I think, part of what the investing
 18 public thinks is happening here is that auditors are
 19 keeping an eye out for circumstances that would appear
 20 to increase the probability that fraud may be
 21 occurring.
 22 I also see fraud as a continuum, as one end

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1 of a continuum of potential problems with a financial
 2 statement, and that in setting standards for risk
 3 assessment, I'm not sure how you -- I think you have to
 4 -- you have to give guidance and more than guidance for
 5 looking for mistakes, looking for conduct, which I
 6 think is somewhere -- I'm not sure of the term of art,
 7 but there is something between a mistake and a fraud.
 8 To me, it's little bit more intentional than a mistake.
 9 And that but for the insistence of an
 10 auditor, that principles of financial accounting have
 11 to be complied with, would go forward. But it's not
 12 somebody forgetting how to add. I don't see how you
 13 give the -- I don't see how you set a set of standards
 14 around risk assessment, taking into account that range
 15 of human behavior, and not embody in it some attitude
 16 toward assessing the risk of fraud. And so, like I
 17 said, I think both is the right answer.
 18 KEITH WILSON: Okay. Thank you.
 19 Just before we move on to Gary, let me just
 20 mention that as a point of clarification, we are
 21 intending that there continue to be a separate standard
 22 related to fraud. But we do feel like there is some

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<p>1 important principles that need to be captured in there, 2 too. So --</p> <p>3 DAMON SILVERS: I was suggesting that the 4 overall fraud standard needs to be strengthened at the 5 same time as you're undertaking this exercise. So I'm 6 sort of the opposite of the person who says do nothing, 7 you know? I say do everything.</p> <p>8 [Laughter.]</p> <p>9 KEITH WILSON: All right. Very good. 10 Gary Kabureck?</p> <p>11 GARY KABURECK: Yes. Thanks.</p> <p>12 Actually, I think Damon said a lot of what I 13 was going to say because I think, Marty, in your 14 opening comments, you had said these standards, these 15 seven things, they can become foundational audit 16 standards as opposed to tactical. And if they're 17 foundational, I think the possible existence of fraud 18 or the auditor's inspection for it is one of the 19 central things auditors do work on, and I think it 20 should be in there.</p> <p>21 I think, again, maybe you want a separate 22 fraud standard of how to deploy audit procedures. But</p>	<p>1 saying. And can you just, perhaps for me, if you start 2 at a forensic audit, right, and then you work your way 3 along the continuum, what -- the vision you're 4 articulating that either came from Treasury or where 5 you want to go -- I'm just trying to understand where 6 you want to go -- where do you put yourself along that 7 continuum?</p> <p>8 So I understand when, you know -- because 9 when you're saying both a separate standard and vetting 10 it on the standards, and we're going to talk about this 11 this afternoon because it's certain in some of the 12 other materials that we got. I'm just trying to 13 understand the vision of where you're -- what you're 14 articulating. Could you do that along the continuum?</p> <p>15 DAMON SILVERS: Well, I mean, I'm like Gaylen 16 in that I don't actually have the text of the fraud 17 standard in front of me, but I will give you -- but I 18 think it's a very fair question because I think we 19 definitely should not be expecting that every audit is 20 a forensic audit. I think that's -- there is a risk of 21 that in this -- there is a risk of that in this way of 22 thinking.</p>
<p data-bbox="690 1035 820 1066">Page 131</p> <p>1 I would think in the risk standards, you would want to 2 come up with an answer to questions is fraud a primary 3 or a secondary audit objective? And do you 4 automatically assume fraud or is it only when evidence 5 of possible fraud emerges, and are you looking for 6 positive or negative evidence?</p> <p>7 I think that should be in the risk standard. 8 And again, maybe in different standards, maybe if we 9 got different goals for them, then in a separate fraud 10 standard, okay, if I have to assume fraud exists as a 11 primary audit objective, how do I actually go about 12 doing that? And what is the standards of a detailed 13 audit performance?</p> <p>14 So I think if these are truly foundational 15 standards, these seven, I don't know how fraud can't be 16 inside of it.</p> <p>17 KEITH WILSON: Thank you. 18 Vin Colman?</p> <p>19 VINCENT COLMAN: Damon, I know you're a 20 lawyer and not an auditor, and I'm an auditor. I do 21 this for a living. Do you mind, I'm just trying to 22 understand, make sure I fully understand what you're</p>	<p data-bbox="1307 1035 1437 1066">Page 133</p> <p>1 VINCENT COLMAN: Right. Because that's what 2 I hear. When you're articulating it, that's what I 3 kind of hear you saying.</p> <p>4 DAMON SILVERS: Yes, that's --</p> <p>5 VINCENT COLMAN: That's why I'm looking for 6 the clarification.</p> <p>7 DAMON SILVERS: Right. And that's absolutely 8 not what I'm saying. What I'm saying is I think that 9 we need to move the dial a bit on the overall audit 10 standard so that there is an overall obligation on the 11 auditor to be -- and I'm sorry. The IT guys tell me 12 there's something wrong with my mike. That we need to 13 move the overall dial on the audit standard to create 14 -- oh, it's my BlackBerry in my pocket.</p> <p>15 [Laughter.]</p> <p>16 DAMON SILVERS: See? I just got one. I just 17 gave in and got one of these things, and I don't know 18 how they -- they're evil. That's what Sam and I have 19 been discussing, the various pernicious qualities of 20 BlackBerrys, both recognizing that neither of us would 21 part with it any more than we'd part with our right 22 arms.</p>

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1 Anyway, no, and I think this is why the sort
 2 of the risk assessment area is one where it's
 3 particularly good -- would be a particularly good idea
 4 to have integrated approach that then embodied this
 5 approach elsewhere. So I think that they need to move
 6 the dial a little bit in terms of auditors having some
 7 obligation to -- some greater obligation than is
 8 currently embodied in the fraud -- in the current fraud
 9 standard to be, to act in a context where there's
 10 essentially a reasonable suspicion.

11 And that then -- and I think you then need to
 12 embody that in areas such as this, that approach in
 13 areas such as this. I don't think that we can create
 14 -- I mean, this was a subject of some extensive
 15 discussion in the Treasury Committee. Some people --
 16 and I think Lynn may feel that my basic approach is not
 17 tough enough. Unfortunately, he's not here at the
 18 moment. Maybe he'll chime in later.

19 Some people felt that we ought to be moving
 20 very much toward a kind of absolute liability standard,
 21 right? You don't find fraud, it's the auditor's fault.
 22 That's -- that is not my view. I think that there are

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1 -- but it's also not my view that fraud is something
 2 unrelated to the audit and looking for fraud is
 3 something unrelated to the audit. I just don't -- that
 4 just doesn't parse with what I think the public's
 5 expectation is of the auditing profession.

6 KEITH WILSON: Greg Jonas?
 7 GREGORY JONAS: I perceive a disconnect in
 8 something, and it's probably just me. So a little
 9 education would help me. But my understanding is that
 10 we've proposed substantive foundational thinking with
 11 these seven standards, that it was well thought out,
 12 that the comment letters have come back. I'm
 13 interpreting your comments to be generally supportive.
 14 And yet you plan to repropose as a next step,
 15 suggesting to me that you see certain major areas that
 16 are broken to the point that you have new thinking that
 17 you want to put in place and expose that for public
 18 comment.

19 Could you elaborate for me on what you think
 20 about your initial proposal that is in a major way
 21 broken that would cause you to want to repropose
 22 because I'm not hearing that in the comments, and

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1 that's the disconnect that I perceive.
 2 MARTIN BAUMANN: I'll start on that, and
 3 Keith can follow on. I think because of the fact that
 4 these are so important in terms of being foundational
 5 standards, we want to make sure that we have it
 6 absolutely right. So I think it's not so much that
 7 what we proposed, we got back comments that indicated
 8 there were significant deficiencies in it. We did get
 9 back good comments, and in some places, we've made
 10 changes in response to those comments. In some places,
 11 we decided not to make changes.

12 But because they -- as I said, we think
 13 they're important enough and so important to the
 14 foundation of the entire audit, the risk assessment
 15 process, planning -- with planning the audit,
 16 considering the impacts of materiality and judgments,
 17 that we want to put it out one more time, let everybody
 18 see how we've amended the proposals, and then just get
 19 comments back and then go final.

20 GREGORY JONAS: So, Marty, help me out with a
 21 little percentage. If, you know, 0 percent would be a
 22 re-exposure of exactly what you had before and 100

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1 percent would be I'm going to change everything I
 2 proposed before, where are you on that continuum, would
 3 you guess, roughly? A 10 percent course correction?
 4 KEITH WILSON: That's a very interesting
 5 question, and I don't know that I've really thought of
 6 it in terms of a specific percentage. Let me try and
 7 say that some of the things that we're contemplating
 8 now and that we're looking at doing with these
 9 standards tend to be more in the areas of refinements,
 10 not major structural changes, if that helps in terms of
 11 the way we're looking at the standards.

12 GREGORY JONAS: That's an 11 percent comment.
 13 [Laughter.]
 14 KEITH WILSON: Okay. You're much more
 15 comfortable with percentages than I am.

16 MARTIN BAUMANN: Given that Keith wasn't
 17 willing to throw out a percentage, I do think it's
 18 closer to the 11 percent than it is to the 100, though.
 19 So, but again, notwithstanding that, given their
 20 importance, we feel let's repropose them and get one
 21 more set of comments and then go final.
 22 Thank you.

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1 KEITH WILSON: Joe Carcello?

2 JOSEPH CARCELLO: I wanted to talk a little
3 bit about the fraud question, Marty. And first of all,
4 I agree with Damon, first of all, on I think an
5 absolute liability standard would be a big mistake. As
6 someone who has spent a lot of my professional career
7 studying fraud, a lot of these frauds are very
8 elaborate, and I don't know if the right answer is to
9 embed the fraud guidance throughout all the standards
10 or keep it separate. So I'm not going to really -- I
11 don't have a strong opinion on that.

12 But I did want to, as some of you in the room
13 know, that we are working -- me and three other people
14 are working with COSO to update the study on fraud that
15 we did in 1999. And although we're not done, we do
16 have some preliminary information that I think is
17 important.

18 First of all, fraud continues to be a big
19 problem. There is well over 300 fraud companies
20 between 1998 and 2007. There is well over 1,000
21 enforcement releases related to those 300 fraud
22 companies. In the '99 study that we did for COSO, the

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1 size of the companies was very, very small. And so,
2 someone could say, well, this is only a problem of very
3 tiny companies.

4 Although, by and large, fraud companies do
5 tend to be smaller, the size of the companies has
6 increased by over a factor of 6. That's not due to
7 inflation, guys. You can do the math.

8 The stock price decline is approximately 20
9 percent at the first disclosure, not necessarily a
10 fraud, the first disclosure that there may be an
11 accounting problem. And bankruptcy, delisting,
12 material asset sales, and other adverse consequences to
13 the firm and their shareholders is significantly more
14 likely than a matched sample of no fraud companies.

15 So this is just, you know, tidbits from my
16 memory, and we're still doing a lot of additional work.
17 But the reason I mention this is just for the Board to
18 understand, for the SEC representatives to understand,
19 since this study comes from your enforcement actions,
20 that this continues to be a major problem in the
21 capital markets.

22 MARTIN BAUMANN: Good. Thanks, Joe, for that

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1 input. And Damon, thanks also for the commentary on
2 fraud.

3 Let's move along to the second topic where we
4 have issued a concept release on confirmations, and Dee
5 Mirando-Gould is going to give you a summary of the
6 comments received there.

7 Thanks, Dee.

Meeting of the Standing Advisory Group

October 14, 2009

9:00 a.m. – 2:30 p.m.

Update on Proposed Standards and Concept Release Issued

Keith Wilson, Dee Mirando-Gould, and
Bella Rivshin

*Associate Chief Auditors, Office of the Chief
Auditor*

Update on Proposed Standards and Concept Releases

- Proposed standards on risk assessment
- Audit confirmations concept release
- Signing the auditor's report concept release

Proposed Standards on Risk Assessment

□ Comment Letters Received

■ Firms and association of accountants	18
■ Academics and associations of academics	4
■ Issuers, business groups, and internal auditors	3
■ Investor representatives	1
■ Other standards-setters	2
■ Other individuals	<u>5</u>
Total	33

Proposed Standards on Risk Assessment

- Key Themes of Comment Letters
 - Support for improving standards for risk-based audits
 - Support for integration of the proposed standards for assessing and responding to risk with the standard for audit of internal control over financial reporting
 - Divergent views on integrating the auditor's consideration of fraud into the proposed standards
 - Suggestions for greater alignment with standards of the IAASB and ASB

Proposed Standards on Risk Assessment

- Key Themes of Comment Letters (cont'd)
 - Other general topics
 - Extent and nature of requirements
 - Use of terms to describe the auditor's responsibilities
 - Organization and style of the proposed standards
 - Effective date of standards