NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on October 14, 2010 that relates to the Board's proposed auditing standard relating to confirmations. The other topics discussed during the October 14, 2010 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SAG MEETING

National Association of Home Builders

1201 15th Street, Northwest

Washington, D.C.

October 14, 2010

8:33 a.m.

Well, we're coming into our final subject of the day and that is, we proposed a new standard with respect to confirmations, the comment period on that is closed and we've received many comments, and I've asked Dee Mirando-Gould to present a summary of the comments received, as we've been doing on other proposed standard-setting initiatives.

So, Dee, you've got the final position.

MS. MIRANDO-GOULD: Thanks, Marty.

So, as Marty said, we proposed a standard on confirmation and the comment period ended on September 13. And before I talk about some of the key themes in the comment letters that we received, I just wanted to go through some of the key requirements -- remind you of some of the key requirements that are in this proposed standard. So, there's a lot of words on this slide, so it's a little hard to read, but we'll go through a little bit of the background on it.

There is a requirement to confirm receivables. We broadened the terminology so it includes receivables that arise from credit sales, loans or other transactions. That terminology is found, actually, in FASB qualification. It also includes a "should confirm" receivables, and that establishes a presumptively mandatory requirement to confirm receivables. And under the Board's Rule 3101, the auditor must comply with requirements of this type, unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objective of the standard. So, thus, this includes -- the proposed standard does not include a discussion of the exceptions to confirming receivables that were in the existing standard.

The proposed standard also includes a requirement to confirm cash with financial institutions and it includes a requirement to confirm other relationships with those financial institutions, including lines of credit, compensating balances, contingent liabilities, including guarantees, and the like.

It includes a requirement to confirm significant risks, or in response to significant risks, but it discusses the fact that confirmation might not be appropriate for all significant risk, because its confirmation should be performed for those significant risks that relate to relevant assertions that can be adequately addressed by confirmation procedures. So, the release is clear that we understand that not all significant risks will be able to be confirmed.

The proposed standard includes requirements around maintaining control consistent with the existing requirement, but there are also some new requirements there. So, for example, it includes a requirement to perform procedures to determine the validity of addresses on confirmation requests. It also includes a requirement around management's requests not to confirm accounts, and actions the auditor should consider to evaluate the implications of those requests.

The proposed standard also includes a requirement for the auditor to evaluate the audit evidence. Now, that also is in the existing standard, but this proposed standard goes a little bit further in that it requires the auditor to perform alternative procedures for all non-responses, it includes requirements for the auditor to investigate each exception on a confirmation response, to assess the reliability of all confirmation responses, to evaluate the effective disclaimers or the restricted language on the reliability of the confirmation process. As we've heard, the inclusion of disclaimers and restricted language in confirmation responses has increased over time.

We received 27 comments on the proposed standard, and the breakdown of the respondents is shown on this slide, so the -- predominantly from accounting firms and the Association of Accountants. And some of the key themes here, we generally received support for pursuing -- continuing to pursue a new standard to replace the existing standard, and primarily that support came from the fact that there have been advances in electronic communication that weren't dealt with under the existing standard.

Some of the other things we heard from respondents are that we should consider modifying the standards to be more principles-based, risk-based, more consistent with the risk-assessment standards. The Board is encouraged to consider additional outreach to learn how the additional confirmation requirements will affect confirming parties, so the standard includes a number of requirements for auditors, but there is no ability to require confirming parties to actually respond to those confirmation requests, so we have been encouraged to consider outreach, to understand that process, to see if we can encourage better responses from confirming parties.

A couple of other areas, the -- we've received comments on the presumption to confirm receivables, and the concern that we didn't include a statement about when exceptions are appropriate. And that's why I mentioned rule 3101, because that covers, the "should" covers any possible exceptions, so there is no need to discuss exceptions in the standard.

The other area was having the audit -- the standard discuss any limitations on the use of internal audit, or refer to the relevant auditing standard, AU Section 322. So, there was some concern that we were planning to change practice, and limit the use of internal audit, and other commenters mentioned that we should have more clear requirements -- discussion of the intent related to internal audit in the standard.

So, I open it up, if anybody has any thoughts or comments about the comment letters we received at this point.

MS. RIVSHIN: Doug Anderson?

MR. ANDERSON: Okay, I'll jump in first this time, maybe in part because I was part of the group that drafted one of those comment letters.

Two things I wanted to say, one was I think I expressed the ergo when SAG talked about this last year. I still believe this is a great example of a rule that's overly prescriptive in how it's structured. I think that, you know, the way paragraphs 8 and 9 are stated brings focus to two elements -- receivables and cash. I love paragraphs 10 and 11 that talks about specific risks and talking about really focusing on the risk. And I know I have seen situations where receivables and cash were not the primary risk areas. And I think we fall into a trap with this, if we start off the discussion saying, "Think about receivables and cash, and oh, by the way, if there's other good risks out there, address those, too," puts it backwards. I think it should be stated, "Look at your risks and look at confirmations as a fabulous way to potentially get audit evidence, base it on the risks of the situation, and two areas you want to give special consideration to are receivables and cash," would be structured more appropriately around the risk of the environment.

And then, of course, being an internal auditor, or recently having been one, I'll just echo the comments you made at the end about the use of internal audit. I think again, there, the way that the current wording is interpreted, back in page 20 of the release basically putting severe limitations around internal audit and how it can be used, again, may not be respective of the environment within a specific company. And I'd rather go back and just rely on 322. The way -- I'm worried if it's written now, and especially in the introduction to the standard, it's written now, it will be interpreted to have a different approach than what we have in the standard right now in the use of internal audit.

MS. RAND: I'd like to respond to Doug's point about -- well, he had two points -- one about being overly prescriptive and then internal audits, I'll start with overly prescriptive.

When we were developing the standard, and I'm kind of thinking about Sam's comments, about principles-based or rules-based, and the reality is, it's a combination of both. And also, Marty's comments yesterday about all our standards, we we're developing, consider the risk of fraud. This standard certainly, as we were developing it was for -- in considering the risk of fraud. Certainly, the requirement to confirm receivables to begin with came from a very significant fraud case, McKesson Robbins. And we even had discussion this morning about the, you know, the concern about overstatement of revenue. So, we had expanded the requirement there.

Cash has also been an area where there's been alleged frauds regarding cash, and even confirmation process. And even in the area of significant risk, our current standard today requires the auditor to at least, you know, consider confirming things like significant or unusual complex terms, bill and hold arrangements, other things -- things that, in our view, would fall under the category of significant risk for which it would be appropriate to confirm.

So confirmations -- and oftentimes, confirmations are used to get information -- to identify frauds, whether, you know, maybe falsification of revenue. So, for all of those reasons, that was really driving our thinking about what to confirm, plus most of the firms today, if they don't explicitly require, they strongly encourage confirmation of cash. So, that led to our thinking in developing the standard and the procedures around it go to consider fraud-risk factors -- testing the validity of addresses, so there the auditor's just not relying on what the company is giving them for where the companies are located, because it could be, you know, one of their best friends, or -- making sure the auditor sends and receives.

And then -- so that was our perspective, and hopefully that helps as far as the standard and how we viewed it.

The other thing on internal audit, what Doug is referring to in the release, we indicated that auditors could use internal, you know, internal auditors, however, in our view, and as we've indicated in the standard, when auditors send and receive confirmations, they shouldn't rely on the company or any other party. In our view, that included internal audit, because in our view you're giving up control, if

I've given it to someone else, I've lost maintaining control over that process. Or even evaluating responses, we thought that was so important for the auditors.

We did get comments saying, "Well, you should just go with 322 and allow that to continue." And I'd be interested if you had any other thoughts on why internal auditors -- why you think it's appropriate for them to send confirmations on behalf of the auditor; how the auditor would still maintain control in that process.

MR. ANDERSON: Yeah, just on those two thoughts -- the first one, I'm not saying the confirmation of receivables and cash are not good, don't get me wrong. It comes into looking at this, instead of relying on issues from a, you know, a big issue from a couple of decades ago to drive how this standard is structured, I think the primary focus always needs to be on auditors need to focus on risk. And we need to be -- have a singular focus on risk, and we need to look at confirmations, respond to that, and then see how to apply that thinking. This standard of structure today, number one thought: beat up on receivables. Well, that may not be the number one thought.

So, it's not that I think confirmation of receivables is wrong, I think it basically just sends the wrong message that maybe a not-so-smart auditor says, "If I deal with receivables and I deal with cash, I must have the big things covered." Well, they may have missed the entire big risk areas of a company. So, it's a question of emphasis and how it's structured in package is what I take issue with. I think it should be more focused on audit risk and designing confirmations for those high-risk areas, not necessarily presume that those will always be receivables and cash with zero balances, as the standard is basically implying now.

And then back to the internal audit, I mean, I've seen a lot of different internal audit functions, and there are some great internal audit functions, and there are some really poor internal audit functions. And I think I'm pretty comfortable allowing the public accountant, the external auditor, assess and evaluate the strength and the weakness of the internal audit functions -- their objectivity, the way that they operate -- as kind of guided by the current standard to decide how best to use internal audit in those circumstances.

It may very well be a case that confirmations are dealing with a medium- or lower-risk area. They still think it's an effective method, but in that risk profile, they're willing to take the situation that they think internal audit is objective, will do it objectively and do it professionally and they go with that judgment.

Right now, the way the standard and the release seems to be worded, you've said there will never be a situation where an internal audit can competently mail out some envelopes. And I'm not sure in every situation, every risk profile for every company with every internal auditor that's the right answer. So, I would leave it up, more of the judgment of the auditor. That's just how I react to what I read.

MS. RAND: Well, and that was in there

internal audit is considered by auditors in two ways. One is, internal audit can do their own work, they may go ahead and send their own confirmations and do tests, and auditors may consider that, reduce the nature, time and the extent of their procedures. So, that part of it remains the same.

The other thing is, they may decide to reduce the nature, time and extent of their procedures, say, based on the work of internal audit and use internal audit as part of their audit team. So, it's counting as part of the auditor's own work, and that's kind of -- that's the part where we were placing, you know, it's so important, it's really your own work, and we think it's important enough that the auditors send it -- send and receive confirmations and evaluate those responses.

MR. BAUMANN: Well, Dee, I guess we -- we've received the comments letters, we're in the process of analyzing them. Doug, thanks for your further comment today.

I think, to a large degree your comment actually, I think, supports one aspect -- certainly, one aspect that we added to the standard, which was for the auditor to confirm significant risks. And so you certainly, I think, supported the concept of a risk approach, and I think you're saying, "Think of our packaging."

So, I appreciate your comments and I think as was said by Jennifer, we are mindful of investors' concerns on the risk of fraud. And it's forefront on the mind of investors, and a we're writing standards -- whether they be the risk assessment standards that have been adopted or other standards that we're proposing, the risk of fraud is high on our list as to the procedures that we require.

Dee, thanks for your presentation of the comments. We'll take all of the comments we receive and letters, obviously, into account as we think about a -- our next steps in this regard and make a proposal to the Board.

Meeting of the Standing Advisory Group

October 14, 2010

8:30 a.m. – 12:45 p.m.

Confirmation – Summary of Comments Received

Dee Mirando-Gould

Associate Chief Auditor, Office of the Chief Auditor

Proposed Standard – Confirmation of Specific Accounts

- Requirement to confirm receivables
  - Includes receivables that arise from credit sales, loans, or other transactions
  - Includes presumptively mandatory requirement to confirm receivables
- Requirement to confirm cash with financial institutions
  - Confirmation procedures with these financial institutions includes –
    - Other relationships, such as lines of credit, other indebtedness, compensating balance arrangements, and contingent liabilities, including guarantees, and
    - Whether, during the process of completing the confirmation response, any additional information about other deposit or loan accounts has come to the attention of the financial institution
- Requirement for significant risks
  - Confirmation should be performed for those significant risks that relate to relevant assertions that can be adequately addressed by confirmation procedures

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Proposed Standard – Confirmation Procedures

- Auditors should maintain control over the confirmation process, including -
  - Sending the confirmation request and not relying on the company or any other party
  - Performing procedures to determine the validity of addresses
  - Requesting confirming parties to respond directly to the auditor and not to the company or any other party
  - Determining whether management requests not to confirm are appropriate, and evaluating implications of the request

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Proposed Standard – Confirmation Procedures

- Requirement for auditors to evaluate the audit evidence obtained from performing confirmation procedures by –
  - Evaluating the audit evidence and not relying on the company or any other party
  - Performing appropriate alternative procedures for each non-response
  - Investigating each exception in confirmation responses
  - Assessing the reliability of confirmation responses, including additional procedures for responses received electronically
  - Evaluating the effect of a disclaimer or restrictive language on the reliability of a confirmation process

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Summary of Comments Received

- Comment Letters Received

Accounting firms and associations of accountants	19
Associations of business groups and internal auditors	3
Academics and associations of academics	2
Confirmation intermediaries	2
GAO	1
Total	**27**

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Summary of Comments Received

- General acknowledgement of the need to revise existing standard
- Respondents recommended -
  - Modifying the standard to be more principles-based/risk-based
  - Additional outreach to learn more about how additional confirmation requirements will affect confirming parties

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Summary of Comments Received

- Respondents recommended (cont'd) -
  - Including in the standard the statement in AU sec. 330.34 that the presumption the auditor will confirm receivables may be overcome if the use of confirmations would be ineffective
  - Having the standard either discuss any limitations on the use of internal audit or refer to AU sec. 322

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