

**Prepared Statement by
Chief Auditor Douglas R. Carmichael on
2006 Proposed Standards-Setting Activities**

**Standing Advisory Group Meeting
October 5, 2005**

I'd like to discuss our standards-setting activities over the past year, and how those activities relate to last year's listing of proposed standards-setting activities.

First, the effective implementation Section 404 of the Sarbanes-Oxley Act was and continues to be a priority for the Board. Section 404 required companies for the first time to file reports to the SEC on management's assessment of the effectiveness of the companies' internal control over financial reporting. Section 404 also required the companies' auditors to attest to and report on the internal control assessments made by management. PCAOB Auditing Standard No. 2 is the standard the auditor must use to report on a company's internal control over financial reporting.

Our list of proposed priorities does not include work on implementation of recent standards, but I would be remiss if I didn't mention the significant effort we have expended – not just in the Standards group but throughout the PCAOB – to ensure as smooth an implementation of Section 404 as possible. We did several things over the past year:

- First, we issued three sets of Q&A's since the last annual meeting.
- Second, the Board participated in the SEC Roundtable on Internal Control Reporting Provisions on April 13, 2005.
- Third, the Board devoted the entire June 8-9, 2005 meeting of the SAG to Section 404 implementation issues. At the June SAG meeting we committed to continuing our dialogue with auditors, issuers, investors, and others on implementation issues arising from Section 404. We also expressed our intent to obtain data from the inspections process, which we are now doing, and to communicate both directly to the firms and more generally to the public whether AS 2 implementation to date has been as effective as it can be and, if not, how it can be made more effective.

In addition to Section 404, fraud continues to be an area of high priority for us. We've discussed fraud, and topics related to fraud, such as related parties and confirmations, in previous sessions with the SAG.

We've also been analyzing our inspection results regarding the firms' implementation of SAS No. 99, which is the Board's interim standard on fraud. SAS No. 99 became effective in 2003 for calendar year-end audits, so it is a relatively new standard for auditors and it incorporates some auditing procedures that were not in the previous auditing standard on fraud. For instance, it requires a brainstorming session among the engagement team to discuss the risks of material misstatement due to fraud. It requires a retrospective review of accounting estimates to assess managements' judgments and assumptions about those estimates. It also requires examining journal entries and other adjustments for evidence of possible material misstatements due to fraud.

We've been analyzing the results from our inspections of firms to determine what is working and what is not. As in the case of Section 404 implementation, we intend to communicate to the firms any concerns we have about the quality of their audit work to address risks associated with fraud. To the extent we find problems common to multiple audit firms, either in relation to Section 404 implementation, considering the risks of fraud in an audit, or in other areas, the Board may also issue, under the Board's Rule 4010, more generalized reports that describe the problems and appropriate solutions.

In addition to Section 404 and fraud, I'd like to discuss some of our other standards activities during the year:

- The Board proposed and adopted a rule on independence and tax services. This rule was motivated by public concern about auditors' sale of aggressive tax shelters to public company audit clients, as well as auditors' provision of personal tax services to managers involved in the financial reporting process of public company audit clients. We received over 800 comment letters on our proposed rule, which took time to analyze, but overall we received significant support for the new rules. We believe that, once the rules are in effect, the investing public will have more confidence that auditors of public companies are not subject to the conflicts of interest that would be posed by auditor involvement in aggressive tax work or by special relationships with individual managers. In addition, auditors seem pleased to have a better sense of what kind of tax work is appropriate for public company audit clients and what kind is not.
- The Board also proposed and adopted a standard on the auditor's reporting on whether a previously reported material weakness continues to exist. This standard establishes a stand-alone engagement that is entirely voluntary, performed only at the company's request. The SAG's input during the early development of this project was very helpful. Based on that input, we believe that in some situations companies will find that auditor assurance that a material weakness no longer exists leads to a

higher level of investor confidence in a company's financial reporting, and that the costs of the engagement are therefore worth incurring.

- The PCAOB released staff Q&A's related to attest engagements regarding XBRL (eXtensible Business Reporting Language) data furnished under the SEC's XBRL Voluntary Financial Reporting Program on the EDGAR system. The staff Q&A's provide guidance for auditors who are engaged to report on whether the XBRL data accurately reflects the corresponding information in the official EDGAR filings. The XBRL voluntary financial reporting program began in April 2005.
- Finally, in addition to our rulemaking and standards-setting activities, during the year we sought the advice of the SAG on items included on our 2005 listing of standards-setting activities, such as the reporting model, reasonable assurance, engagement quality review, communications with audit committees, risk assessment, and the codification of PCAOB standards and the authority of PCAOB interim standards.

With that as a backdrop, let me now present the listing of the 2006 proposed standards-setting activities. All of the topics included on the list have been discussed during at least one SAG.

Before getting into the individual items included on the list, I'd like to give the same caveat that I did last year regarding our then proposed activities, which is that we do not anticipate that all of the projects will be completed in 2006 as final standards of the Board. Rather, several of these projects may result in proposals for public comment sometime during the year, and we expect to continue to work on the others internally. Additionally, the activities could change based on emerging issues that may arise during the year. We are seeking your advice and input on the list to better assist the Board in making a determination about its 2006 standards-setting activities.

The proposed 2006 standards-setting activities are as follows:

Engagement quality review – Section 103 of the Sarbanes-Oxley Act requires the Board to adopt an auditing standard on concurring or second partner reviews of audits. We call such reviews engagement quality review, to reflect the core goal of such reviews to improve the quality of individual engagements. The SAG discussed engagement quality reviews last year. Since then we've made substantial progress on a proposed new standard, and we've learned more information about engagement quality reviews through our inspections process. However, an area where we'd like further input and advice from the SAG is on engagement quality reviews in smaller public accounting firms. A panel discussion has been scheduled for this SAG meeting to pursue that area.

- Fraud (including related parties and confirmations) – Fraud remains a priority for us, and I previously described our activities and progress in this area. We believe we can enhance auditor performance in fraud detection by making changes to the existing interim standards, which include direction to the auditor on various specific areas such as revenue

recognition and significant unusual accruals, rather than establishing a new standard. Therefore, there is a notation on the slide to indicate that this standards-setting project is considered a “review of existing standards.” We don’t intend to create an entirely new standard, but instead we plan to update/amend the existing interim standards in key areas such as auditing related party transactions and appropriate use of the confirmation process. We will also consider whether the existing standard adequately describes the auditor’s responsibilities under the federal securities laws. We also plan to consider how an auditor’s consideration of the risks of fraud relate to the concept of reasonable assurance, a topic we will discuss later at this meeting.

- Communications with audit committees – This is a project to update the existing standard on auditors’ communications with audit committees in light of new requirements imposed by the Sarbanes-Oxley Act, such as the discussion of critical accounting policies and practices, and alternative treatments of financial information within GAAP. The SAG discussed auditor communications with audit committees last year. As we’ve worked on this standards-setting project, however, we realized that we’d like information from audit committee chairs on how auditors interact with audit committees today, and we would like the SAG to consider that information and provide advice as to whether, and if so, how, current practices should be reflected in the auditing standard. Therefore, a panel discussion has been scheduled for this SAG meeting to further pursue the topic.

This project is also denoted as a review of existing standards, because we believe we can update/amend the existing interim standard on communications with audit committees rather than creating an entirely new audit standard.

- Principles of reporting (meaning of “present fairly in conformity with GAAP,” consistency, and adequacy of disclosure) – This project was included in our 2005 listing of activities as a result of an exposure draft issued by the FASB in December 2003 that would require companies to retroactively apply a newly effective FASB standard on voluntary changes in accounting to previously issued financial statements. Last year we recognized that users of the financial statements may not understand the difference between a restatement due to the adoption of a new FASB standard and a restatement that corrects a material misstatement in previously issued financial statements. In 2005, the FASB issued a final standard, FASB No. 154, and at tomorrow’s meeting of the SAG we will seek advice and input from the SAG on the need for changes to the auditing standards as a result of the issuance of FASB No. 154.

In addition to making changes as a result of FASB No. 154, we will also be considering whether other changes are necessary to make certain reporting standards into permanent standards of the Board. For instance, the SAG’s input on the phrase “presents fairly in conformity with GAAP” adequately expresses the auditor’s opinion that financial statements are not misstated or misleading is

an example of the other types of changes we are considering. Accordingly, this project is denoted as a review of existing standards.

Fair value (including use of specialists) – This project includes the auditor's procedures to obtain evidence to determine whether a company's method of measurement is appropriate and whether management's assumptions are reasonable and supported. We discussed fair value with the SAG last year based on an exposure draft developed by the FASB on fair value measurements and disclosures. The FASB has yet to finalize a standard on this topic; however, we are monitoring their activities, as we did with FASB No. 154 on reporting. Also, this project includes the auditor's use of specialists, since specialists often play a critical role in determining and assessing fair value estimates.

In addition, we have been working on and will soon issue staff Q&A's on auditing fair value measurements related to stock based compensation pursuant to FAS 123R.

Risk assessment (including audit planning, procedures, and evaluating audit findings) – This project reevaluates the auditor's risk assessment process, and includes the auditor's understanding of the entity and its environment, assessment of the risks of material misstatement of the financial statements, and the linkage between the assessed risks and the nature, timing, and extent of auditing procedures performed in response to those risks. We discussed risk assessments with the SAG last year, and we are continuing to move forward with this project.

- Quality control (including independence quality controls) – This project is mandated by the Sarbanes-Oxley Act to include supervision of audit work, acceptance and continuance of engagements, internal inspection, hiring, professional development and advancement of personnel, consultation within a firm on accounting and auditing questions, and monitoring of professional ethics and independence from issuers. We discussed quality control with the SAG last year, and we are continuing to move forward with this project. In that regard, we are considering a separate standards project on independence quality controls, which is an element of an accounting firm's system of quality control. A major source of information for us in the area of quality control comes from our inspections process, and we are incorporating information gained from inspections to assist us in this area.
- Codification of PCAOB standards/ Authority of PCAOB interim standards – The Board has adopted 4 new auditing standards, and so far each of the four has been number sequentially. We are considering whether organizing new standards based on the progression of an audit or some other substantive framework could be more useful to auditors and others using PCAOB standards. In addition, we are considering what authority the interpretive and other auditing publications that are including in the PCAOB interim standards should have in relation to the permanent standards of the PCAOB. Both of these topics were discussed with the

SAG last year, and we are continuing to move forward with both these projects.

With that as the background of the proposed 2006 standards-setting activities, I'd now like to open up the discussion for your input and advice on the listing of topics.