

Standing Advisory Group Meeting
Standards-Setting Priorities
As of October 18, 2007

This is the annual meeting of the Standing Advisory Group. At this meeting the Office of the Chief Auditor ("OCA") will present to you for discussion the Board's standards-setting priorities. I will start this session with a report on our standards-related accomplishments over the past year followed by an overview of the topics the PCAOB standards-setting staff believes should have the highest priority. I will then open the floor to discussion.

Accomplishments during the Past Year

To set the stage for this discussion, I believe it is important to describe the significant standards-related accomplishments since last year's annual SAG meeting, as it will give you a sense of where the standards-setting staff and the Board have devoted their substantive attention and resources. Many of these accomplishments relate directly to the priorities we discussed last year, or are related to other matters important to members of this Group. The first of our slides includes a listing of these accomplishments.

AS2 Revision –

The Board remains focused on the successful implementation of the internal control reporting provisions of the Sarbanes-Oxley Act. Last year we described the Board's four-point plan and some of the efforts that ultimately led to Auditing Standard No. 5 ("AS No. 5"),

which will supersede the Board's Auditing Standard No. 2. In February, we devoted a considerable portion of the SAG meeting to discussing potential changes to the internal control auditing standard. On May 29 of this year, the Board adopted AS No. 5, which was subsequently approved by the Securities and Exchange Commission in July.

Yesterday, the PCAOB published for public comment staff guidance on auditing internal control over financial reporting in smaller public companies. The guidance was developed with the generous assistance of representatives from twelve registered public accounting firms. We also benefited from the assistance of the SEC staff and review and comment from several smaller public companies. Auditors may use the guidance immediately. The comment period provides an opportunity to further improve the document. We are now focusing some additional attention to the delivery of education on the new auditing standard to smaller auditing firms, that would be in addition to what we historically have provided in our PCAOB Forums on Auditing in the Small Business Environment.

We have had considerable interaction with our colleagues in Inspections throughout the internal control project. Inspections staff were involved in each step of our AS No. 5 project, providing input based on their inspections experience generally and specifically with regard to the implementation of AS No. 2, the Board's initial internal control auditing standard. The OCA remains involved in the development of the inspections approach and is participating in the

development and delivery of inspections training on the new internal control auditing standard. OCA staff also assist our inspectors in evaluating inspections findings and in communicating those findings to the registered firms.

As a side note, our experience with internal control illustrates the range of interaction between the various divisions of the PCAOB. Other PCAOB divisions, such as the Office of Research and Analysis and the Office of General Counsel, also provide input on each standards-related project.

I expect this subject to continue to require a measurable portion of our resources over the next twelve months. Activities in this area will include completion of the small-firm guidance, participation in the inspections process, and education for smaller auditing firms.

Principles of Reporting –

The next item on the list is principles of reporting. On April 3rd of this year, the Board published a Proposed Auditing Standard, *Evaluating Consistency Of Financial Statements*, and Proposed Amendments To Interim Auditing Standards. This proposal was made in response to two actions by the Financial Accounting Standards Board ("FASB"). One is the issuance by the FASB of Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, which revised the accounting for and disclosure of accounting changes in financial statements. The other is the FASB proposal to incorporate the hierarchy of generally accepted

accounting principles into a new accounting standard. This "GAAP hierarchy" currently resides in the auditing standards.

The comment period on this proposal ended in May and we currently are working to complete revisions to the proposal based on the comments.

Independence and Prohibited Services –

Also on April 3rd, the Board published a Concept Release Concerning the Scope of Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*. Based on the comments received on the Concept Release, the Board, on July 24th, published a proposed amendment to Rule 3523 and a proposed new Rule 3526.

The proposed amendment to Rule 3523 would change the scope of the rule to apply only to the professional engagement period rather than to the audit and professional engagement period. Proposed Rule 3526, *Communication with Audit Committees Concerning Independence*, is an updating of one of the Board's interim independence standards, Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees* ("ISB No. 1"). The proposal modestly expands the auditor's communication responsibility. The proposed rule would require the auditor, prior to accepting an initial engagement under the standards of the PCAOB, to describe, in writing, to the audit committee all relationships between the auditor (and any affiliates of the auditor) and the potential audit client or persons in a financial reporting

oversight role at the potential audit client that may reasonably be thought to bear on independence. As is the case with ISB No. 1, the auditor would be required to make a similar communication to the audit committee annually thereafter.

The comment period on these proposals ended in September and we currently are working to complete revisions to the proposals based on the comments.

Other Accomplishments –

I would like to briefly describe certain other specific accomplishments since last year's annual SAG meeting.

- On October 17, 2006, the staff issued a set of staff Questions and Answers to help auditors audit the fair value of share options granted to employees. This set of staff Questions and Answers explains how to apply the Board's existing auditing standards to the fair values determined in applying FAS 123R and the SEC's Staff Accounting Bulletin No. 107. The guidance outlines the overall approach to auditing the fair value of option grants and focuses auditors' attention to the aspects of the valuation that have the most effect.

- On April 3, 2007, the staff issued another set of staff Questions and Answers, this one on Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees. These questions and answers are intended to assist in the implementation of PCAOB Rules 3522, *Tax Transactions*, and

3523, *Tax Services for Persons in Financial Reporting Oversight Roles*.

- On January 22, 2007, the Board issued an inspection report pursuant to its Rule 4010, which is titled, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud*. The report is a summary of observations made in the course of the Board's inspections that are principally related to the way in which the inspected firms implemented Statement on Auditing Standards No. 99, *The Auditor's Consideration of Fraud in a Financial Statement Audit*. The observations summarized in the report are sufficiently important or arise with sufficient frequency to warrant discussion in a public report, both for the purpose of generally focusing auditors on being diligent about these matters and for the purpose of providing information that audit committees may find useful in working with auditors. The Office of the Chief Auditor worked closely with the Inspections Division in preparing that report. I am hopeful that this report will help all registered firms improve their focus on their responsibilities for fraud in a financial statement audit, and I encourage auditors to obtain and read it.

- On April 18, 2007, the Board issued another inspections report pursuant to Rule 4010, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. OCA staff assisted Inspections in preparing that report.

Priorities as of October 2007

I now would like to switch topics to our current priorities. The items on the next two slides are a listing of current priorities, matters we expect to give substantive attention to at some time during the next twelve months. I expect that some, and not all, of these items will result in either proposed or final adopted standards or rules during the next twelve months.

Internal Control

Although it is not included on the list of standards setting priorities, the effective implementation of the internal control reporting provisions of the Act will continue to be a focus of this organization. Now that AS No. 5 has been approved, our focus is on its implementation, and in making sure that registered firms have the information and training they need to appropriately implement the new standard. This will continue to require the PCAOB to devote resources in this area.

Independence and Principles of Reporting –

As I indicated several minutes ago, we recently proposed standards and rules in the areas of independence and reporting, and we intend to complete those projects in the very near term.

Engagement Quality Review –

The next item on the list is engagement quality review. Section 103 of the Sarbanes-Oxley Act of 2002 requires the Board to adopt in

its auditing standards a requirement for a concurring or second partner review and approval of each audit report, and concurring approval in its issuance. We refer to the concurring or second partner review as the engagement quality review because we believe this term is more reflective of the objective of the review. The SAG has discussed engagement quality reviews on two separate occasions. We also have worked closely with PCAOB inspectors in developing a draft standard, so this is an example of a project in which the PCAOB, as a standards setter, has been able to utilize knowledge gained through our inspections process. We have made substantial progress on this project, and it remains one of our top priorities.

Risk Assessment, including fraud risk assessment –

In the risk assessment project, we are reevaluating the auditor's risk assessment process, which includes the auditor's understanding of the company he or she is auditing and the company's environment, the auditor's 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 the auditing procedures performed in response to those risks.

Improvements in the auditing standards regarding risk assessment could encourage the appropriate integration of the audit of the financial statements with the audit of internal control over financial reporting by, for example, re-framing the interim auditing standards to articulate a risk-based integrated audit process more directly.

We have heard some concern that auditors are not consistently effective at assessing risk and then responding appropriately. Additionally, our inspectors have observed some cases in which auditors did not respond appropriately to fraud risk factors. This project will give us an opportunity to further study and address these matters.

Similarly, our inspectors have observed some cases in which auditors appear to have approached their consideration of fraud as an isolated, mechanical process rather than an integral part of the audit. The staff is evaluating how the auditor's fraud risk assessment should be integrated with the auditor's overall risk assessment. We believe there is an opportunity to clarify, in the professional standards, this relationship.

The International Auditing and Assurance Standards Board (IAASB), and the U.S. Auditing Standards Board have revised their auditing standards to enhance the auditor's risk assessment process. We are evaluating the work of those two boards.

This is a large project that affects several of the Board's interim auditing standards. Last year, we reported our plans to make substantial progress on this project over the ensuing twelve months. Our efforts regarding internal control have advanced our thinking on these issues as we determine the appropriate direction for assessing and responding to risk in an integrated audit. This is an important project and we plan to make substantial progress during the next twelve months.

Fair Value –

We continue to keep our eyes on developments with regard to fair value accounting. Issuers were permitted to adopt Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, this year and the new standard becomes mandatory in 2008. Issuers also were permitted to adopt SFAS 159, *Fair Value Option*, this year. We have engaged in regular dialog with the SEC, the FASB, auditors and issuers, to assess whether there are emerging auditing issues. Measurement of fair value also is affected by the recent sub-prime mortgage and liquidity issues in the market place, which we discussed with the SAG in June.

We have been evaluating the existing auditing standards on auditing estimates, auditing fair values, and using the work of specialists – all of which are pertinent to the audit of fair value measurements – to determine whether any changes to the Board's standards or additional staff guidance are needed. While some aspects of those standards will become obsolete once SFAS 157 becomes mandatory for all companies, the majority of the principles in those standards still apply. So, from an immediate perspective, we believe auditors will be able to apply the direction in those standards to the new accounting. We are, however, considering whether some guidance would be helpful.

Eventually, it will be appropriate for us to update those standards. I have included this topic on the list of standards-setting

priorities because of the likelihood that we would begin a project to update the related standards at some time in the next twelve months.

Specialists –

Last year we identified three projects that were in the second tier of priority, projects we expected to begin during the ensuing twelve months: related parties, confirmations and specialists.

In the specialists project, we would reevaluate the auditor's use of specialists, either when a company engages or employs a specialist and the auditor uses that specialist's work as evidential matter in performing an audit, or when the auditor engages a specialist and uses that specialist's work as evidential matter.

The SAG has discussed issues relating to specialists. The IAASB and Auditing Standards Board also have projects-in-process the use of specialists. We are monitoring those projects, and will consider their results.

Although we did not begin a standards-setting project on this subject during the past twelve months, specialists is a subject we have given substantive attention in connection with our monitoring of developments in fair value accounting. It continues to be a priority and is a project we expect to begin soon.

Related Parties –

In the related parties project, which will include consideration of fraud risk, we will reevaluate the auditor's obligation for the

identification and evaluation of related parties and related-party transactions, and consider what direction is needed to help auditors satisfy that obligation. We recently began working on this project at the staff level.

Confirmations –

In the confirmations project, we would reevaluate the auditor's use of confirmations to corroborate a company's account balances and transactions directly with third parties. The existing standards do not address all areas for which direct confirmation with third parties may be preferable to applying other audit procedures, and certain practice issues, such as when management requests the auditor not to confirm; and authenticating confirmation responses received electronically. This project also would consider fraud risk.

We were not able to devote attention to this project during the past year. We continue to see this as a priority, however.

Action Plan for Review of Interim Standards –

When the Board adopted existing standards of the AICPA on an initial, transitional basis in April 2003, the Board indicated that it would establish a schedule and procedure for the review of all the interim professional auditing standards. We have not yet established such a schedule or procedure; rather, we have focused our standards setting resources on specific priorities, which is consistent with advice we have received from the SAG.

At the beginning of 2007, the staff began evaluating each of the Board's interim auditing standards to begin the process of identifying the level of change necessary to adopt the standards as permanent standards of the Board, and to begin to formulate views as to their relative priority. Our next step is to develop a more defined schedule and procedure for this review with the Board. I expect that we will seek additional advice from the SAG on this subject next year.

Other Matters Affecting Priorities

Global Auditing Standards

There are three other matters not on the priorities list that I would like to bring to your attention.

There has been considerable discussion about the need for, and progress has been made toward, a single set of high-quality accounting standards for both domestic and cross-border financial reporting. Later today, we will consider possible auditing issues associated with the use of International Financial Reporting Standards to prepare financial statements for use in the United States.

Increasingly, questions are being raised about the need for uniform auditing standards for both domestic and cross-border financial reporting purposes. In the coming year, as we consider various aspects of our standard setting role moving forward, I expect that we will seek the SAG's views on whether there is a need for a set of globally accepted auditing standards, how the PCAOB should

interact with other auditing standards setters, and how this should fit within the PCAOB's other priorities, including our approach to acting on the Board's interim professional standards.

XBRL

The second matter I wish to draw to your attention is XBRL, or Extensible Business Reporting Language. I expect that you all are familiar with this subject. In a nutshell, what XBRL does is to make financial information identifiable by computers, so that the information can be more readily disseminated, analyzed and used. The private sector has been developing this technology for some time and, more recently, the SEC, under Chairman Cox's leadership, has taken steps to encourage its implementation. Steps taken by the SEC include the XBRL Voluntary Financial Reporting Program, the recent release of the source code for the interactive financial report viewer, and the creation of the Office of Interactive Disclosure.

As this initiative develops, the PCAOB staff will be working closely with the SEC to address auditors' responsibilities with regard to XBRL-tagged data.

Federal Advisory Committees

Finally, there are two federal advisory committees focused on the accounting profession. The SEC established the Advisory Committee on Improvements to Financial Reporting to examine the U.S. financial reporting system with the goals of reducing unnecessary complexity and making information more useful and

understandable for investors. The U.S. Department of the Treasury established the Advisory Committee on the Auditing Profession to provide informed advice and recommendations to the Secretary of the Treasury and the Department of the Treasury on the sustainability of a strong and vibrant public company auditing profession. Recommendations from these two committees might affect PCAOB priorities.

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These topics represent our view of our standards-setting priorities as of today. Of course, changes in circumstances and new developments can result in changes to these priorities and can affect our ability to make progress on these matters.

With that as the background of the proposed standards-setting priorities, I would now like to open up the discussion for your input and advice.