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Prepared Statement By Chief Auditor Thomas Ray on 2007 Standards-Setting Priorities

Standing Advisory Group Meeting October 5, 2006

This is the PCAOB's annual meeting of its Standing Advisory Group. At this meeting the Office of the Chief Auditor will present to you for discussion the Board's standards-setting priorities. This discussion will include projects we currently are working on as well as ones we expect to begin working on during the next year. I also will report on certain other standards-related projects we have worked on since last year's annual SAG meeting.

Because there is some overlap between the matters we gave substantive attention to over the last year and our current priorities, I believe it will be most helpful to first discuss the projects the PCAOB staff believes have the highest priority. In connection with that discussion, I will brief you on our activities related to those projects over the past year. I will then turn to projects we expect to begin working on during the next twelve months.

The priority of some of the items we discussed last year has been changed, and I will give you our thoughts as to why. Also, there are a number of other things we accomplished over the last year that do not fit into the other categories of discussion, and I will finish my presentation with a summary of those items. I will then open the floor to discussion.

Priorities

First, I will talk about the four standards-setting projects we currently are working on.

AS2 Revision –

Since the Board adopted Auditing Standard No. 2, we have been focused on its successful implementation. On May 10 of this year, the PCAOB and the Securities and Exchange Commission held a roundtable on second-year experiences with the internal control reporting requirements of the Sarbanes-Oxley Act of 2002. Following the roundtable, on May 17, the Board announced a four-point plan in continuation of its efforts to assist in the implementation of AS2. At our June meeting, the PCAOB staff provided a more detailed overview of the four-point plan, including the details of certain possible revisions to AS2. We also obtained valuable input from the SAG on the PCAOB's plan, including the possible revisions to AS2.

In addition to preparing a draft of a revised AS2, the staff has begun to facilitate the development of implementation guidance for auditors of smaller public companies, one of the items in the four-point plan. We also continue to support our colleagues in inspections as they inspect the firms' implementation of our auditing standard.

I expect these activities to continue to require a considerable portion of our resources over the next twelve months.

Principles of Reporting –

In 2005, the Financial Accounting Standards Board issued 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. Last year, we discussed with the SAG the changes needed to the corresponding auditing literature to conform to Statement No. 154. The FASB also has proposed to incorporate the hierarchy of generally accepted accounting principles into a new accounting standard. This "GAAP hierarchy" currently resides in the auditing standards. Accordingly, we would propose to remove that hierarchy from the auditing standards as it no longer would be needed. We have made substantial progress on a project that will address both of these areas.

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, most recently last year with a focus on small firm implementation. Since then, we have taken time to more fully evaluate what we are learning in the inspections process about engagement quality reviews that are being conducted under the Board's interim concurring partner standard, and have made substantial progress on this project.

Risk Assessment, including fraud risk assessment –

In this 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.

The International Auditing and Assurance Standards Board (IAASB), and the U.S. Auditing Standards Board recently revised their auditing standards to enhance the auditor's risk assessment process. We are evaluating the work of those two boards. In addition, over the past year, the staff has begun to evaluate how the auditor's fraud risk assessment should be integrated with the auditor's overall risk assessment, and we believe there may be an opportunity to clarify this relationship.

This is a large project that affects several of the Board's interim auditing standards. We have made progress in analyzing the issues, and are in the preliminary stages of our project. We plan to make substantial progress on this project over the next 12 months.

Projects Beginning Over the Next Year

We have identified three projects in the next level of priority. We expect to begin these projects during the next year based on the SAG's input and further discussion with the Board.

Related Parties (including consideration of fraud risk factors) –

In this project, we would reevaluate the auditor's obligation for the identification and evaluation of related parties and related-party transactions.

Related parties and related-party transactions have proven difficult for auditors, because such transactions are not always easily identifiable and the substance of the transactions is not always readily apparent. While the auditing standard and related auditing interpretation encourage the auditor to evaluate related-party transactions as a high risk area, auditors sometimes rely primarily on management and the company's principal owners to identify related parties and related-party transactions.

We would evaluate what direction is needed to help auditors understand the procedures that are necessary to obtain reasonable assurance that related parties and related-party transactions are identified, appropriately disclosed, and do not contain misstatements that are material to the financial statements taken as a whole.

We previously listed this project underneath the broader heading of fraud, but now we believe it is appropriate to undertake a separate standards-setting project on this subject. This project, nevertheless, would address fraud risks.

Confirmations (including consideration of fraud risk factors) –

In this 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. For example, existing standards do not direct the auditor to confirm cash account balances – although in my experience, that is a customary practice – or the terms of significant transactions or agreements. The existing standards also do not address certain practice issues, such as when management requests the auditor not to confirm; how related party confirmations differ from confirmations to independent third parties and the circumstances in which related party confirmations should be used; and authenticating confirmation responses received electronically.

Similar to related parties, we previously listed this project underneath the broader heading of fraud. Although this project would consider fraud-related issues, we believe it is appropriate to undertake a separate standards-setting project on this subject.

Specialists (including how specialists are used in fair value measurements) –

In this 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.

Specialists are used in determining valuations – including fair value measurements – used in financial statements, determining the physical characteristics relating to quantity of assets on hand or their condition, determining amounts by using specialized techniques or methods, and interpreting technical requirements, regulations, or agreements.

Earlier this year, the SAG discussed issues relating to specialists. Based on that feedback, and given the increased use of fair value measurements in financial reporting, we are planning to undertake a separate project to reevaluate the auditor's use of specialists.

The IAASB currently has projects-in-process on related parties, confirmations, and specialists. The Auditing Standards Board also has projects-in-process on related parties and the use of specialists. We are monitoring those projects, and will consider their results.

Activities Removed from the List

We have removed three items from the 2006 standards-setting priority list in order to add the three projects I just described. We believe the three projects I just described will have a greater effect on audit quality than the three we are removing and, accordingly, carry a higher priority. The projects that have been removed from the list include:

Communications with Audit Committees –

We decided in our first year that it would be beneficial to update the existing auditing standard on auditors' communications with audit committees in light of new communication requirements imposed by the Sarbanes-Oxley Act and the change in the relationship between the auditor and the company, also brought about by the Act. Our experience, however, does not support our continuing to have this project as a top priority, given other priorities of the Board. Auditors do not seem to be having trouble identifying matters that must be communicated to audit committees. We also have not identified any auditing issues that have arisen because the auditing standards have not been updated to reflect the nature of the auditor's legal relationship to the company, as outlined in the Act.

Quality Control Standards –

Quality control standards are standards that apply to firms, rather than to the individual audit engagements. The objective of these standards is to provide the auditing firm with reasonable assurance that its personnel will adhere to the appropriate ethical standards and that the professional engagements are conducted in accordance with the relevant professional standards.

In our first year, we thought it would be appropriate to prioritize our reevaluation of the Board's interim quality control standards. We now believe that the priority of this reevaluation should be changed, to provide more time to learn about this subject through our inspections process and to allow us to address other projects.

Removing this item from the list of standards-setting projects does not mean the PCAOB will drop its focus on firms' systems of quality control. Quite the contrary. Our inspections process focuses on significant aspects of the firms' quality control systems and is a major source of information for us in the area of quality control.

We will continue to evaluate information from our inspections division about the effectiveness of firms' quality control systems, and will undertake a project to reevaluate the quality control standards when it appears appropriate and necessary to do so based on our inspection results.

Codification of PCAOB standards and authority of PCAOB interim standards –

This was actually two projects, one to evaluate the way in which the Board's standards are organized and presented and one to address the authority of certain of the Board's interim standards. We believe that developing a codification of the Board's permanent standards is a good idea, but at this time we don't believe it is a priority. Additionally, the matter we had identified with regard to the authority of the PCAOB interim standards does not appear to be causing an issue in practice.

Although these projects have been removed from the list of proposed 2007 activities, we will continue to monitor the related issues, evaluate emerging issues, and consider whether additional guidance or new or revised standards are needed to resolve them.

Other 2006 Activities

I would like to report on several other standards-related projects we have worked on during the past year.

Fraud –

We have been analyzing the inspection results on the firms' implementation of Statement on Auditing Standards (SAS) No. 99, which is the Board's interim auditing standard on the auditor's responsibility to evaluate and respond to the risk that fraud has caused the financial statements to be misstated. SAS No. 99 became effective in 2003. In addition to evaluating how the inspection results should affect our standards-setting, we still are considering whether it would be helpful to issue a public report pursuant to the Board's Rule 4010 on the implementation of SAS No. 99. Rule 4010 provides the Board with a means to publish a summary report on its inspections findings.

Fair value –

We have been monitoring the Financial Accounting Standards Board's activities with respect to new accounting standards on fair value measurements and disclosures. On September 15, 2006, the FASB issued a new standard, FASB Statement No. 157, *Fair Value Measurements*. Earlier this year, the FASB also exposed for comment a proposed accounting standard that would provide companies with the option to report certain financial instruments at fair value.

We are 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 – in light of the FASB's standards setting to determine whether any changes to the Board's standards or additional staff guidance are needed.

Staff Q&A on predecessor auditors –

On June 9, the PCAOB published staff questions and answers to provide guidance to auditors with regard to adjustments to prior-period financial statements that were previously audited by another auditor.

Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, requires that all voluntary changes in accounting be applied retrospectively to all prior periods presented, unless it is impracticable to do so. The previous accounting standard required that most voluntary changes be accounted for in the period of the change. Accordingly, when there has been a change in audit firms, questions will arise more frequently as to which auditor – the newly appointed auditor or the previous auditor – can audit and report on retrospective adjustments made by the company. The staff questions and answers provide guidance and illustrative reports for auditors encountering such circumstances.

Staff Audit Practice Alert on stock options –

On July 28, the PCAOB issued a Staff Audit Practice Alert, *Matters Related to Timing and Accounting for Options Grants.* The Alert was prepared by the PCAOB's Office of Research and Analysis, working in conjunction with the PCAOB's Office of the Chief Auditor. The alert advises auditors about practices that may have implications for audits of financial statements or of internal control over financial reporting and discusses factors that may be relevant in assessing the risks related to these matters. This topic was discussed with the SAG in June as an emerging issue.

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