

Standing Advisory Group Meeting

Standards-Setting Accomplishments and Priorities

As of October 23, 2008

As this is the annual meeting of the Standing Advisory Group, we will present the Board's proposed standards-setting priorities for the upcoming year. The session will start with a report on our standards-related accomplishments to date this year followed by an overview of the topics the Board believes should have the highest priority. We will then open the floor to discussion and we welcome your input.

Accomplishments during the Past Year

The significant standards-related accomplishments since last year's annual SAG meeting indicate where the standards-setting staff and the Board have devoted their substantive attention and resources. Many of these accomplishments relate directly to the priorities that were discussed last year. The first of our slides includes a listing of these accomplishments.

Proposed Auditing Standards – Risk Assessment

Earlier this week, the Board proposed for public comment seven auditing standards that would, collectively, update the requirements for assessing and responding to risk during an audit. This is a significant project and it addresses core concepts underlying the audit – such as, identifying and assessing risks of material misstatement, the auditor's responses to the risks of material misstatement; evaluating audit results, audit planning and supervision, consideration of materiality in planning and performing an audit, audit evidence, and audit risk in an audit of financial statements. Future auditing standards would build on the fundamental principles in them.

We believe that the Board's proposed risk assessment standards, if adopted, would result in improvements to audits of issuers in several ways.

- First, the proposed standards would update the existing requirements to take account of the improved risk-based audit methodologies currently in use by some auditors.
- Second, the proposed standards should enhance the integration of the audit of the financial statements with the audit of internal control over financial reporting, resulting in more effective audits. Improvements in the standards also address financial statement only audits.
- Third, the proposed auditing standards would integrate the auditor's current responsibilities for considering the risk of fraud during the audit.

This integration would emphasize that consideration of fraud is a central part of the audit process and should prompt auditors to make a thoughtful and thorough assessment of fraud risks and develop appropriate audit responses.

- Finally, the proposed standards reflect an effort to reduce unnecessary differences with the risk assessment standards of other standard setters.

The proposed standards were issued for a 120-day comment period. Comments are due February 18, 2009.

Proposed Auditing Standard – Engagement Quality Review

On February 26th of this year, the Board proposed a new auditing standard, *Engagement Quality Review*, which would supersede the interim concurring partner review requirement. Section 103 of the Sarbanes-Oxley Act 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 Board received 38 comment letters on the proposed standard, most of which came from the auditing profession and issuers. Many of the letters included alternatives to the proposed requirements. The staff is in the process of carefully evaluating the comments received. In response to these comments, the staff plans to make a recommendation to the Board in the next few months.

Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists

On December 10, 2007, the staff issued Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*. This alert was issued in response to developments in the credit markets, and the difficulties of determining fair values when direct observations of prices in an active market are not available. The alert reminds auditors of their responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. The alert focuses on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment. The alert remains relevant to issues being raised about fair value measurements in the current economic environment.

Auditing Standards No. 6, Evaluating Consistency of Financial Statements

On January 29, 2008, the Board adopted Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, and amendments to its interim standards that supersede AU sec. 420, *Consistency of Application of Generally Accepted Accounting Principles*. Auditing Standard No. 6 and the related amendments also removed the hierarchy of generally accepted accounting principles from the interim auditing standards. The Board adopted the auditing standard in response to the FASB issuing FAS No. 154, *Accounting Changes and Error Corrections*, and FAS No. 162, *the Hierarchy of Generally Accepted Accounting Principles*. On September 16, 2008, the SEC approved Auditing Standard No. 6. This standard and the conforming amendments are effective 60 days after SEC approval. That is, this standard becomes effective on November 15, 2008.

Ethics and Independence Rule 3526 and amendment to Rule 3523

On April 22, 2008, the Board adopted an ethics and independence rule, Rule 3526, *Communication with Audit Committees Concerning Independence*, to enhance the communication between the auditor and the audit committee by requiring 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. Rule 3526 supersedes the Board's interim independence requirement, *Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees*, and two related interpretations. The Board also adopted an amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*. The amended Rule 3523 does not prohibit tax services provided during the portion of the audit period that precedes the beginning of the professional engagement period. The amendment to Rule 3523 became effective on August 22, 2008, the date the SEC approved both this amendment and Rule 3526. Rule 3526 became effective on September 30, 2008.

Other activities

In addition to standards-setting projects, it is important to mention that there are a variety of other activities in which the staff in the Office of the Chief Auditor is involved. For instance, OCA contributes substantial amounts of time in order to assist the PCAOB's other divisions and offices, by, among other things, advising and consulting on projects and activities, reviewing inspection reports and enforcement recommendations, and responding to inquiries from external parties. OCA staff devotes time as an observer in various activities of the Financial Accounting Standards Board as well as in various international standards-setting activities. OCA staff meets regularly with representatives from

the Government Accountability Office and the U.S. Auditing Standards Board to discuss respective standards-setting activities. OCA staff has been involved in monitoring the SEC and Treasury Advisory Committees. Finally, OCA staff is involved in participating at various educational programs, including the PCAOB's Forums on Auditing in the Small Business Environment.

Priorities as of October 2008

Next we would like to outline our current priorities. The items on the next slide include a listing of current priorities, which are matters we expect to give significant attention to during the next twelve months.

Adopting Standards Proposed in 2008

As was mentioned earlier, in 2008, we proposed new auditing standards on engagement quality review and risk assessment. These projects will remain a priority for us. We intend to complete engagement quality review in 2009. We similarly intend to complete the risk assessment standards in 2009, although the timing is subject to the comments we receive from exposure.

Fair Value and Specialists

The staff has devoted significant time in evaluating the current auditing standards relating to fair value and specialists. We are considering both standards contemporaneously because specialists are used increasingly by both auditors and management with respect to fair value measurements. The staff has been following the developments in the current credit crisis and evaluating how the current economic environment may affect the development of new auditing standards.

As it relates to fair value, this project encompasses updating the existing standards on auditing accounting estimates, auditing fair value measurements, and auditing derivatives and financial instruments. These are three separate standards under the Board's interim standards.

In the specialists' project, we are evaluating the requirements regarding the auditor's use of specialists in instances where a company engages or employs a specialist and the auditor uses that specialist's work as evidential matter in performing an audit, and where an auditor itself engages a specialist and uses that specialist's work as evidential matter.

The fair value and specialists' project is a very high priority and the staff anticipates that a concept release will be issued for public comment by the end of 2008.

Confirmations

In the confirmations project, we are reevaluating 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 is also considering fraud risk as it relates to confirmations. The staff has devoted significant time to this project in the last several months and anticipates that a proposed standard will be issued for public comment in early 2009.

Related Parties

In the related parties project, we are reevaluating the auditor's obligation for the identification and evaluation of related parties and related-party transactions, as well as fraud risk factors, and considering what direction is needed to help auditors satisfy that obligation. The staff has devoted significant time to this project in the last several months and anticipates that a proposed standard will be issued for public comment in 2009.

Guidance for Auditors of Smaller Companies relating to AS No. 5

On October 17, 2008, the PCAOB published for public comment staff guidance on auditing internal control over financial reporting for smaller public companies. The comment period provided an opportunity to further improve the guidance. The staff has considered the comments received together with input from our inspections group on observations of auditor implementation of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The staff plans to finalize the staff guidance by the end of the year.

Action Plan for Review of Interim Standards

Last year we mentioned that the staff began formulating some preliminary views with respect to the Board's interim standards. As you are aware, shortly after the Board's inception, the Board adopted the existing standards of the AICPA on an initial, transitional basis, and indicated that a schedule and procedure for the review of the interim standards would be established. In fulfilling the Board's objective, we plan to develop a concept release to obtain public comment and feedback regarding the Board's review of the interim standards. We may also seek additional advice from the SAG on this subject next year. We anticipate issuing a concept release in early 2009.

Consideration of Work of Other Standards Setters

Finally, in connection with our standards-setting priorities, we plan to consider the work of other standards-setters as we work on individual projects. For instance, we will consider the IAASB's standards on fair value, specialists, confirmations, and related parties. We will also consider relevant work of other standards setters and regulators. For instance, as part of developing the proposed risk assessment standards, among other things, we made an effort to reduce unnecessary differences with other standard setters. We are seeking feedback on that approach but, regardless of our approach in writing standards, we will continue to evaluate relevant work of other parties.

Other Matters Affecting Priorities

There are several other matters not on the priorities list that are worthy of being highlighted.

Federal Advisory Committees

First, as you are aware, there were two federal advisory committees which focused on the accounting and auditing profession in 2007 and 2008. The SEC established the Advisory Committee on Improvements to Financial Reporting (CIFiR Committee) to provide advice to the SEC on the U.S. financial reporting system with the goal 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 (Treasury Advisory Committee) to provide advice and recommendations to the Department of the Treasury on the sustainability of a strong and vibrant public company auditing profession. While a few recommendations of the CIFiR Committee involved the PCAOB, the Treasury Advisory Committee made a number of recommendations related to the PCAOB.

The CIFiR Committee issued its final report on August 1, 2008 and the Treasury Advisory Committee issued its final report on October 6, 2008. Both reports outline recommendations to the SEC, FASB, and the PCAOB. Several of the recommendations relate directly to standards-setting. At the February SAG meeting, the SAG discussed the CIFiR Committee recommendation relating to professional judgment, and during this meeting the SAG has discussed two Treasury Advisory Committee recommendations relating to signing the auditor's report and the feasibility of developing key indicators of audit quality and effectiveness.

At this time, the Board is in the process of evaluating the recommendations from these two federal advisory committees relating to the PCAOB.

Change in Accounting Standards

The staff works closely with and monitors FASB's projects related to accounting standards because changes in accounting standards may affect the Board's auditing standards. For example, earlier this month, the FASB issued exposure drafts for two proposed accounting standards – *Going Concern* and *Subsequent Events*. The Office of the Chief Auditor is currently evaluating these exposure drafts and considering whether the Board's auditing standards will need to be amended in light of the proposed accounting standards. The staff is also monitoring the FASB developments relating to the accounting for loss contingencies project.

Securities and Exchange Commission actions

The staff is also monitoring two SEC projects, one relating to International Financial Reporting Standards (IFRS) and the other relating to Extensible Business Reporting Language (XBRL). Specifically, the staff is monitoring the SEC's project on potentially allowing US issuers to prepare financial statements in accordance with IFRS. The staff is evaluating what type of effect the SEC's project will have on the Board's interim standards.

Additionally, in May 2008, the SEC issued for public comment a proposed rule on mandating the use of a XBRL-based filing program, *Interactive Data to Improve Financial Reporting*. The proposal does not require any form of auditor assurance in XBRL-submitted documents, but did seek commenter's views regarding whether the involvement of auditors should be required. The staff is monitoring the SEC's activities and will revisit the PCAOB staff questions and answers, which was issued in May 2005 and addresses attest engagements regarding XBRL information furnished under the XBRL Voluntary Financial Reporting Program on the EDGAR system, to determine if any changes are necessary once the SEC finalizes its rule.

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These topics represent our view of our standards-setting priorities as of today. The final set of priorities is determined based on the results of the PCAOB's oversight of registered public accounting firms, monitoring of the environment, and consultation with the Board's Standing Advisory Group, among other factors. The standards-setting process includes, among other things, consideration of the results of the Board's oversight activities, the work of other standards setters, advice from the SAG, and research, and solicitation of public comments. The Board and its staff carefully consider the priority level of each potential standards setting project, and allocate staff and Board resources accordingly. Obviously changes, such as in the economic climate as well as any new legislative initiatives, could cause the Board to adjust its priorities over the year.

With that as the background of the proposed standards-setting priorities, we would now like to open the floor for discussion.