

May 24, 2007, Open Meeting

**Introductory Statement of Chairman Olson
On the New Standard Concerning
The Audit of Internal Control**

This July will mark the fifth anniversary of the Sarbanes-Oxley Act, and much has happened since July 2002. When many people refer to Sarbanes-Oxley, they are in fact referring to Section 404, which set forth new provisions related to internal control over financial reporting for all U.S. public companies. As over 50 percent of U.S. households are now equity holders in one form or another, Congress mandated in Section 404 (a) that CEOs and CFOs of companies choosing to access U.S. public markets should have to disclose to investors whether their companies' internal control over financial reporting is effective. In Section 404 (b), Congress mandated an audit of internal control.

Even though Congress had acted in the area of internal control more than once before, the Act's requirement for quarterly management certifications, annual management assessments of controls, and independent auditor attestations of those assessments raised corporate responsibility for internal control over financial reporting to a higher level. On the heels of the corporate scandals that surged in 2000-2001, there was a broad-based sentiment that these enhanced requirements were necessary to restore integrity to, and confidence in, financial reporting.

The PCAOB has been focused on the implementation of the internal control audit for the past several years. Since adopting Auditing Standard No. 2 (*An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*) in 2004, the Board has closely monitored its implementation. In May of last

year, before I joined the Board, my Board colleagues, all of whom were here at the time, made a commitment to revisit AS 2, and we are here today – a year and one week since that commitment was made – to consider a new standard to replace it.^{1/}

The PCAOB's action today is a reflection of the Board's belief in the importance of internal control to reliable financial reporting. With so many investors in the United States and around the world invested in U.S. companies, we owe it to them to see that there is a quality audit over internal control within these companies. At the same time, investors and public companies alike benefit from regulatory balance. Therefore, the PCAOB has been driven by the need to identify changes that would preserve the important benefits of the standard, and meet the statutory objectives of the Act, without resulting in the performance of unnecessary audit procedures. In December, at our open meeting, I emphasized the need for a standard that would help bring about a better alignment between the costs and benefits of the internal control audit.

With regard to benefit, I am encouraged that many companies that are now subject to Section 404 requirements are starting to show the benefits of internal control over financial reporting (based on disclosures that are now available to the public). The first two years of their reporting on internal controls tell us a great deal about the progress made already, and findings -- as of April 2007 -- for year three appear to support a continuing, positive trend. While the costs of internal controls have seized attention, we should not lose sight of the visible benefits. An analysis of reporting data indicates encouraging trends:

- From the first year of compliance with Section 404 to the second, there was a decline in the overall number of opinions on ICFR that describe material

^{1/} As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2. See PCAOB Press Release, Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements (May 17, 2006). The other aspects of the plan are: (1) reinforcing auditor efficiency through PCAOB inspections; (2) developing or facilitating development of implementation guidance for auditors of smaller public companies; and (3) continuing PCAOB Forums on Auditing in the Small Business Environment.

weaknesses. The results as of April 1, 2007, indicate that this trend is continuing in year three.²

- Restatements are also declining for companies subject to Section 404, which is in contrast to the restatement rate for those not yet subject to its requirements.³ This suggests that internal control over financial reporting is helping companies identify and fix problems in advance of having to restate.

These signs of benefits are encouraging. I am also encouraged by what I am hearing from corporate America. The consistent feedback that I get from corporate board members and CEOs of accelerated filers is that they are better companies due to internal control over financial reporting. But, they continue to express concern about unnecessary burden.

On December 19, 2006, the Board proposed for comment a new standard on auditing internal control that would replace Auditing Standard No. 2.^{4/} At that time, I encouraged auditors, investors, issuers and all others who rely on corporate financial statements to tell us whether the proposals clarified Board expectations, reduced unnecessary work, and retained the important benefits of an audit of internal control. The public comment process for a standard of this significance is tremendously important. The comments received – 175 in all – further informed our thinking. The standard, and related rule and amendments, that we are considering today reflect our careful consideration of the comments. We are grateful to the array of commenters who took the time to provide their analysis.

The Board asked staff to scrutinize the comments against the provisions of the proposed standard with the goal of eliminating unnecessary requirements for internal

² Data were compiled from Audit Analytics for reports on internal controls filed as of April 1, 2007.

³ Data on financial restatements were compiled from Audit Analytics, for restatements filed as of December 31, 2006.

^{4/} See Proposed Auditing Standard: An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements and Related Other Proposals, PCAOB Release No. 2006-007 (Dec. 19, 2006).

control reporting, while developing a standard that will require auditors to obtain sufficient evidence to provide an opinion on a company's internal control.

We have carefully studied the comments received so that the recommendations before us today reflect the full benefit of the comment period. We have also worked closely with counterparts at the SEC to ensure that the recommendations are consistent with the guidance provided by the Commission at its open meeting in April, which included the importance of appropriately coordinating the standard with the SEC's management guidance adopted at the SEC's open meeting yesterday. This alignment is important for auditors and issuers.

In a moment, Thomas Ray, our Chief Auditor and Director of Professional Standards, and his team will present to the Board the staff's recommendation for a final standard to replace AS 2, a related independence rule, and conforming amendments to the Board's auditing standards.

I commend Tom and the staff for their intellectual fortitude and old-fashioned hard work that has brought the standard and its related rule and amendments before the Board today. Staff has worked creatively to find solutions and been steadfast when it mattered most.

To present the staff's recommendation on this agenda item, I will now turn to Tom Ray.

**Statement of Chairman Olson
On the New Standard Concerning the Audit of Internal Control**

A motion has been made and seconded, so the question before the Board is whether to adopt the new standard for the audit of internal control over financial reporting and the related rule and conforming amendments presented to us today by staff.

Before I ask my fellow Board members for their comments, I want to express my sincere gratitude to Tom Ray, Laura Phillips, Sharon Virag, Sam Guzman, Dima Andriyenko, Gordon Seymour, Jacob Lesser, and all the other staff involved in this important initiative, for their hard work over the past year on the new standard. As we moved from the proposal stage to a final standard, these individuals have maintained a remarkably high-level of commitment.

I would also like to recognize the commitment of my fellow Board members. Each Board member has invested a tremendous amount of time in the effort to develop the final standard. Each has been engaged on every important issue involved. The Board dialogue has helped to illuminate issues of significance and develop viable solutions. I would like to thank each of you for your role in crafting this standard.

The standard that the Board will consider today reinforces the Board's expectation that the integrated audit be conducted in a manner that eliminates procedures that are unnecessary to an effective audit of internal control and increases the likelihood that material weaknesses will be found before they allow material misstatements to occur. The new standard should drive important improvements in the audit of internal control.

In my view, the standard, rule and related amendments that Tom Ray and his team have just described meet the objectives set forth in the four-point plan issued by the Board in May 2006. Importantly, the package before us today is also responsive to the comments received on the proposals and the guidance provided by the SEC. I would like to acknowledge the important and open dialogue we have had with Chairman

Cox and the SEC Commissioners, and the value the SEC staff has added to this initiative.

Earlier this morning, I mentioned some of the important benefits of internal control over financial reporting and the accompanying audit. To preserve these benefits, throughout the process of replacing Auditing Standard No. 2, we have been careful to retain the fundamental principles that are essential to an effective internal control audit. By doing so, we have maintained our focus on the need for -- and right of -- investors to receive fairly stated financial statements and complete and accurate disclosure about the effectiveness of internal control.

Key Aspects of the Final Standard

Before turning the discussion over to my colleagues, I would like to highlight four aspects of the final standard that, in my opinion, will make a genuine difference and promote a balanced approach to the audit of internal control over financial reporting:

(1) A principles-based approach

In my view, principles-based audit standards are necessary to assure that the auditor, at every step of the audit process, can take into account the individual facts and circumstances of a particular company. Depending on the nature of the audit client and its control environment, the auditor may utilize different combinations of procedures. A principles-based standard gives the auditor room to exercise judgment in determining what specific procedures are required in order to obtain sufficient evidence. We have made an effort in developing AS 5 to provide appropriate room for judgment, which is underscored by the top-down approach to the audit process. At the same time, the standard provides a sufficient framework to assure that an audit performed in accordance with its requirements will be effective. A principles-based standard has the flexibility to be scaled for an audit of a global company spanning several continents or a very small company.

(2) Scalability

Scalability, in my mind, is closely tied to the principles-based approach. When developing the proposal, the Board placed significant emphasis on assuring the scalability of the internal control audit. I strongly support the approach to scalability reflected in the final standard.

By incorporating the discussion of scaling concepts throughout the standard, rather than in one specific section, we have strengthened the impact of scaling. That is, the top-down, risk-based approach is fundamentally designed so that an auditor will tailor the audit to the specific profile of a company. Smaller, that is, non-accelerated, filers are still in the preparatory stage for complying with internal control requirements. I believe they will benefit from the scalability built into AS5, which will be reinforced by the guidance on auditing internal control in smaller companies that will be issued later this year.

(3) Fraud controls

Every company has an inherent level of fraud risk, and auditors must be cognizant of that risk in each audit. The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Based on comments received, there are several changes to the standard that Tom Ray and his team have just outlined.

I strongly support the added emphasis we have given to fraud risk and anti-fraud controls in the final standard. This should make clear to auditors the importance of assessing fraud risk throughout the audit process. I support the move to incorporate the auditor's fraud risk assessment – required in the financial statement audit – into the auditor's planning process for the audit of internal control. This is another important way to promote audit quality and improve integration with the financial statement audit.

While even the strongest of internal control frameworks cannot provide absolute assurance that fraud will be prevented or detected, a strong control environment should help to reduce instances of fraud. This emphasis on fraud controls in the internal control audit ultimately enhances investor protection.

(4) Aligning with the SEC Management Guidance

Yesterday, the SEC adopted guidance to help management evaluate internal control for purposes of its annual assessment. Management's assessment and the audit of internal control are distinct, yet complementary, steps in the Section 404 process of providing assurance to investors about the reliability of companies' internal control. Many of our commenters emphasized the importance of these steps being more closely aligned. While management's process and the audit should work together, management and the auditor have different perspectives on the company's internal controls, and the assessment and audit have different objectives under Section 404.

Therefore, I support the changes proposed by staff to better align AS 5 and the SEC's management guidance. It is essential that general concepts necessary to an understanding of internal control are described in the same way. I am pleased, therefore, by the decision to use the same definitions and terminology where relevant.

Implementation

Our work will not end today. We are well-aware that adopting a balanced standard is only part of our overall initiative. Equally important is sound implementation once the Board adopts a final standard. In the coming months, the Board and staff from Standards and Inspections will work closely with audit firms on effective implementation of AS 5. Our inspection program will be adjusted to be consistent with the new standard.

Our intention in acting today is to have the new standard in place in time for the 2007 audits. We will continue to watch AS 5 implementation carefully, in part, because

companies and the controls they use will evolve, and auditors will gain more experience and identify better, more effective ways to carry out their audits of internal control.

As with other standards, we must keep current so that our expectations remain reasonable. The new standard's principles-based approach provides room for companies and auditors to evolve, and the Board will work closely with its inspections staff to assure that we remain informed and allow for innovation.

In sum, I support the adoption of the new standard as presented to the Board today. It directs auditors on how to right-size the audit of internal control, which is expected to eliminate unnecessary work. At the same time, it safeguards the important objectives of Section 404. I encourage those involved in the financial reporting process to hear our message today and move forward to implement the PCAOB's new audit standard, as well as the SEC's management guidance, in a manner that enhances governance over financial reporting and provides greater assurance to investors that financial reporting is fair and accurate.

I will now turn to my fellow Board Members for any discussion.