At its public meeting on December 19, 2006, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") will consider whether to propose and seek comment on two auditing standards, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements* and *Considering and Using the Work of Others*; an independence rule, *Audit Committee Pre-approval of Services Related to Internal Control*; and related amendments to the Board's interim standards. This briefing paper highlights the reasons for the proposals and describes their more significant provisions.

**Reasons for the Proposals**

In June 2003, the Securities and Exchange Commission ("SEC") implemented Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") by adopting rules requiring issuers to include in their annual reports an assessment of the company's internal control over financial reporting as well as an auditor's report on that assessment. Soon after, as required by Sections 404(b) and 103 of the Act, the Board adopted Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2"), to apply to the newly required audits. The SEC approved AS No. 2 on June 17, 2004.

Two annual financial reporting cycles have been completed since public company auditors began applying AS No. 2 to audits of the largest public companies.
During this time, the PCAOB has closely monitored implementation of the standard and the progress auditors have made in complying with its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing on the Small Business Environment; and reviewing academic, government, and other reports and studies.

From all of these sources of information, two basic propositions have emerged. First, the audit of internal control over financial reporting has produced significant benefits. Issuers and auditors have described a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls. Corporate board members have noted an improvement in audit committee oversight, while investors have found public company financial reporting to be of higher quality and enhanced transparency.

Second, these benefits have come with significant cost. Over the last two years, the Board has heard a consistent message that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs than expected. The Board agrees that auditors should perform internal control audits as efficiently as possible for companies that are required by the SEC’s rules to obtain an audit report on internal control. With this in mind, the Board has evaluated every significant aspect of the audit of internal control to determine whether the existing standard encourages auditors to perform procedures that are not necessary in order to achieve the intended benefits. The proposals result from that evaluation.

**Significant Provisions of the Proposals**

**Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements.** The proposed standard would supersede AS No. 2 and is designed to focus the auditor on the matters most important to internal control, eliminate unnecessary procedures, simplify and shorten the standard by reducing detail and specificity, and make the audit more scalable for smaller and less complex companies. Among other things, the proposed standard would:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment;
Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness;

Clarify the role of materiality, including interim materiality, in the audit;

Remove the requirement to evaluate management's process;

Permit consideration of knowledge obtained during previous audits;

Direct the auditor to tailor the audit to reflect the attributes of smaller and less complex companies;

Refocus the multi-location testing requirements on risk rather than coverage; and

Recalibrate the walkthrough requirement.

The Board will also consider whether to issue for comment certain related proposals that would facilitate the Board's efforts to make audits of internal control more effective and efficient. These related proposals are described below.

Proposed Auditing Standard - Considering and Using the Work of Others. The proposed standard would supersede AU sec. 322 and the direction currently contained in AS No. 2 regarding using the work of others. Among other things, the proposed standard would:

Allow the auditor to use the work of others, and not just internal audit, for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits;

Encourage greater use of the work of others by requiring auditors to evaluate whether and how to use the work of others to reduce their testing;

Require the auditor to understand the relevant activities of others and determine how the results of that work may affect the audit;

Provide a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested; and
• Eliminate the principal evidence provision previously included in AS No. 2.

**Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal Control** – The proposed new independence rule would replace direction currently contained in AS No. 2 regarding independence and internal control-related services. The proposed rule is intended to ensure that audit committees are provided information relevant for them to make an informed decision on how the performance of internal control-related services may affect auditor independence.

**Proposed Amendments to the Board’s Interim Standards** – The Board will consider proposing amendments that, among other things, would:

• Simplify the internal control standard by moving certain information currently contained in AS No. 2 to other existing interim standards. For example, the proposed amendments would move the auditor's responsibilities for management's internal control certifications under Section 302 of the Act into AU sec. 722, Interim Financial Information; and

• Change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion."

**Public Comment**

If the Board issues the proposals, it will seek comment on them for a 70-day period. The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

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