At its public meeting today, the Public Company Accounting Oversight Board (“the Board” or “PCAOB”) will consider whether to adopt Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements; an independence rule, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control; and conforming amendments to the Board’s auditing standards. If adopted and approved by the Securities and Exchange Commission (“SEC”), Auditing Standard No. 5 will supersede Auditing Standard No. 2, the Board’s existing standard on auditing internal control.

Auditing Standard No. 5 and the related rule and amendments result from the Board’s monitoring of auditors’ implementation of Auditing Standard No. 2, through, among other things, inspections of internal control audits and public roundtable discussions held in April 2005 and May 2006. While the Board observed that the audit of internal control produced significant benefits, including higher quality financial reporting, it also noted that, at times, the related effort has appeared greater than necessary to conduct an effective audit.

On December 19, 2006, the Board proposed for public comment the standard, rule, and amendments under consideration today. The Board received 175 comment
letters on its proposals. This paper provides an overview of the rulemaking package the Board will consider.

**Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements**

Auditing Standard No. 5 is designed to achieve the following objectives:

- *Focus the audit of internal control on the most important matters.* Auditing Standard No. 5 clarifies how auditors should assess risk to focus on the areas that have a reasonable possibility of containing a material misstatement, and to calibrate the amount of testing necessary based on the degree of risk. The standard emphasizes the significance of fraud risk and anti-fraud controls, and explains what impact entity-level controls might have on the tests of other controls.

- *Include only the requirements necessary for an effective audit.* The Board has re-evaluated every area of the internal control audit to determine whether Auditing Standard No. 2 encouraged auditors to perform procedures that are not necessary to achieve the intended benefits of the audit. Auditing Standard No. 5 focuses the multi-location direction on risk rather than coverage; requires the auditor to assess risk at the assertion rather than control level; and removes barriers to using the work of others. In addition, Auditing Standard No. 5 does not require the auditor to evaluate management's evaluation process.

- *Make the audit scalable to fit the size and the complexity of any company.* In coordination with the Board’s ongoing project to develop guidance for auditors of smaller companies, Auditing Standard No. 5 explains how to tailor the audit of internal control to fit the size and complexity of any public company.

- *Simplify the text of the standard.* The text of Auditing Standard No. 5 is simpler and easier to use than that of Auditing Standard No. 2. It focuses more on general principles than on detailed requirements and uses plain English to define key terms and describe important concepts.

The Board will consider several changes to its proposals in response to comments. These changes reflect refinements, rather than significant shifts in approach. In particular, the standard under consideration:

- Aligns key terms and concepts with terms used in SEC rules and guidance.
- Includes a discussion of fraud risk and anti-fraud controls at the beginning of the standard to emphasize the importance of these matters in assessing risk.
- Explains how different kinds of entity-level controls have different effects on the selection and testing of controls. For example, entity-level controls that monitor the operation of other controls in a precise manner may reduce the need for testing of the underlying, process-level controls.
Focuses auditors on fulfilling the objectives that a properly performed walkthrough achieves rather than requiring performance of a walkthrough which, under some circumstances, might lead to a checklist approach.

Emphasizes that auditors need not scope the audit to find deficiencies that, individually or when aggregated with other deficiencies, do not constitute material weaknesses. At the same time, the standard retains the requirements to evaluate all deficiencies that are identified and communicate both material weaknesses and significant deficiencies, in writing, to the audit committee.

 Allows auditors to tailor their top-down approach to the circumstances of individual companies by removing the requirement to specifically identify major classes of transactions and significant processes before identifying relevant assertions.

**Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control**

Rule 3525 would require a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related non-audit services that are not otherwise prohibited to: describe, in writing, to the audit committee, the scope of the proposed service; discuss with the audit committee the potential effects of the proposed service on the firm's independence; and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524.

**Conforming Amendments to the Board's Auditing Standards**

The Board also will consider a number of conforming amendments to its auditing standards. These amendments would simplify the internal control standard by moving certain information currently contained in Auditing Standard No. 2 to the existing interim auditing standards, update references in the auditing standards to reflect Auditing Standard No. 5, and change the previously existing requirement related to the date of the auditor's report.

**Effective Date**

Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Act. If the Board adopts Auditing Standard No. 5, it may be used by auditors immediately following SEC approval, and it, along with the independence rule and the conforming amendments, would be required for all audits of internal control for years ending on or after November 15, 2007.
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