

**DECEMBER 19, 2006 OPEN MEETING**

**AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS  
INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS -- PROPOSED  
AUDITING STANDARD NO. 5 AND RELATED PROPOSALS**

**Statement of Daniel L. Goelzer**

Auditing Standard No. 2 has had a major impact on the way public company audits are conducted and on the relationship between public companies and their auditors. Along with the Sarbanes-Oxley Act requirement that managements assess and report on controls, AS No. 2 has also had a dramatic effect on public company reporting, as companies identified and corrected previously-undetected problems in their financial statements. In short, for several years, the impact of Auditing Standard No. 2 has overshadowed much of the rest of the Board's work.

At the same time, AS No. 2 has proven more controversial than probably anyone anticipated when it was adopted in March 2004. There have been real benefits in terms of stronger controls and more reliable financial statements as a result of internal control reporting and auditing. But those benefits have clearly come at a very significant cost.

With the perspective of nearly three years of experience, it has become clear that there are improvements and clarifications we can make to reduce those costs without eroding the benefits. During the last seven months, we have gone back to the basics and re-written the standard from scratch with a view to making it more risk-focused and principles-based. To illustrate what we have done --

- Proposed Auditing Standard No. 5 would steer auditors toward spending their time and attention on controls that have the greatest potential to prevent or detect material misstatements. To underscore this point, AS No. 2 terminology like "more than remote" and "more than inconsequential" -- which apparently confused the message as to the importance of a risk-based approach -- has been abolished.
- AS No. 5 is designed to increase the likelihood that control auditing will serve as an early warning system. There is more pay-off for investors from nipping in the bud material weaknesses that may lead to materially inaccurate financial reporting than there is in merely acknowledging after-the-fact that something has gone wrong and that a restatement is necessary to correct erroneous information already in the public's hands.

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- AS No. 5 would, more clearly than its predecessor, explicitly recognize the importance of company-wide, control environment factors. For example, particularly at smaller companies, things like the integrity, competency, and diligence of management and the audit committee have more to do with reliable financial reporting than does the perfection of process-level controls over day-to-day transactions.

Along with balancing costs and benefits, the other major driver behind the new standard is the need to make internal control auditing scaleable for smaller companies. By "scaleable", I mean that the cost of the internal control audit should be proportional to the size and complexity of the company. As the Board's observer to the work of the SEC Advisory Committee on Smaller Public Companies, I heard repeatedly that small and medium sized businesses did not believe that AS No. 2 was scalable. Accelerated filers with market capitalizations below about \$787 million-- the Advisory Committee's cut-off for smaller companies -- felt particularly strongly that the costs of internal control auditing hit them disproportionately.

I believe that the risk-based, control environment-focused approach to auditing in AS No. 5 will go a long way to addressing this problem. AS No. 5 also includes a separate section on scalability that contains specific guidance on how the attributes of a smaller, less complex company affect the audit. Because of the importance of smaller companies to our economy, and of their ability to access the public capital markets, it is essential that we get this aspect of the standard right. I hope that the scalability concepts in the proposal will generate substantial comment.

Finally, I want to emphasize that there are limits to what we can accomplish through a new auditing standard, no matter how thoughtfully it deals with issues like focusing on risk and scaling the audit to the company. How a standard is implemented matters almost as much as its words. Recognizing that, the Board announced in a statement issued last May 17, that -- in addition to revising AS No. 2 -- it would take other steps to improve efficiency in internal control auditing.

Specifically, the Board said that it would use the inspection program to make sure firms are doing their work in the most efficient manner. We know that our inspections are a powerful lever over how auditing is performed. Using that lever to good advantage may be as important as the recasting of Auditing Standard No. 2 in making internal control auditing workable.

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We also promised to facilitate the development of guidance for internal control audits of smaller companies. And, we committed to continuing and enhancing our Small Business Forums, which provide education to smaller audit firms. As the SEC follows through on its decision to bring non-accelerated filers under the Section 404 reporting and auditing umbrella, our success in making good on those promises will also be critical to avoiding the kind of confusion and flight of smaller companies from the public markets that some fear could result.

I want to conclude by joining my colleagues in thanking the staff of the Chief Auditor's Office, particularly Tom Ray, Laura Phillips, and Sharon Virag, for their hard work and dedication. We often acknowledge the efforts of staff members when the Board considers the results of a challenging project. In this case, however, the words "hard work" and "dedication" carry a special meaning. The people sitting before us have been working on internal control auditing almost non-stop for over three years. With respect to the AS No. 5 phase, the Board received a first draft of a revised standard on June 12 -- more than six months ago. Since then, there have been innumerable revised drafts, internal meetings, and status reports. There has been extensive staff-to-staff discussion with the SEC. Through it all, they have maintained extraordinary poise, professionalism, commitment -- and even a remarkable level of good cheer. Thanks for a job well done!