2006 Annual Report

PCAOB

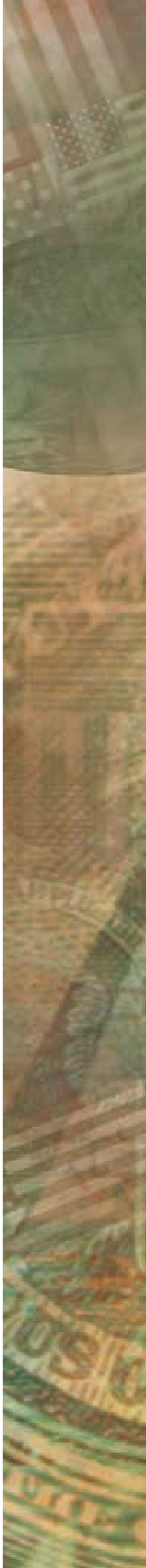
Public Company Accounting Oversight Board

Strengthening Investor Confidence

THE PCAOB MISSION

The Public Company Accounting Oversight Board is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

After four years in operation, the PCAOB has established a strong foundation for the oversight of public company auditors. Countries around the world are developing their own systems of auditor oversight. With increased globalization, we all have a stake in promoting vibrant, transparent markets and strengthening investor confidence around the world.



Chairman's Letter

Mark W. Olson, *Chairman*

On behalf of the Public Company Accounting Oversight Board, I am pleased to present this report on our activities during 2006. During 2006, the PCAOB continued to evolve from a start up to a more steady-state organization. With several solid years of experience behind it, the PCAOB began to refine and further develop its supervisory oversight program to assure that it fulfills the statutory duty of overseeing auditors of public companies in order to protect the interests of investors. When I joined the Board as Chairman in July 2006, a number of important program initiatives were already underway, and others have since been started that should enable the PCAOB to meet the challenges of 2007 and beyond.

Strategic planning is the key to meeting these challenges. During 2006, the Board developed a comprehensive approach to strategic planning, including seeking advice in this regard from its Standing Advisory Group. This effort will culminate in a multi-year plan that will serve as an important tool for assuring that PCAOB program initiatives are implemented according to the Board's strategic objectives and tied to the PCAOB's budget. I expect the strategic planning process will directly affect every program and every employee as we become more effective in aligning our day-to-day activities with our strategic objectives.

In December 2006, the Board published a set of proposals that would supersede the PCAOB's existing standard on An Audit of Internal Control over Financial Reporting (AS No. 2), which the Board adopted in 2004 pursuant to Section 404 of the Sarbanes-Oxley Act (Act). These proposals were the result of many months spent monitoring and evaluating the implementation of AS No. 2, through both the inspection process and ongoing dialogue with representatives of investor groups, public companies, audit firms, the Securities and Exchange Commission (SEC), and other interested parties. These proposals were designed to provide auditors the flexibility to tailor the audit of internal control based on risk (that is, scaled to the size and complexity of each public company). Although these proposals will likely be modified by the Board in light of comments received, I expect that the revised standard will reduce burdens while retaining the substantial benefits companies and investors have received from improved internal control over financial reporting since the adoption of AS No. 2. I also believe this initiative underscores the Board's willingness to respond to well-founded concerns and constructive suggestions of its diverse stakeholders.

Although the pending revisions to AS No. 2 were a key focus of the Board during 2006, the PCAOB also effectively discharged its other program responsibilities, including the broadening of its research and risk analysis activities. These efforts, in addition to our inspection, enforcement, and standards-setting programs, enabled

The PCAOB continued to fulfill its Congressional mandate to protect investors through the oversight of registered accounting firms, utilizing a supervisory model that integrates its registration, inspection, standards-setting, enforcement and support functions.

the Board to effectively supervise approximately 1,750 registered public accounting firms that audit, or are eligible to audit, U.S. public companies. In carrying out its supervisory mandate, the PCAOB seeks to achieve the right balance of oversight and regulation. The Board also continued to refine its supervisory model for overseeing registered firms—a process that integrates all of the Board's programs.

An ongoing challenge facing the PCAOB relates to the inspection of registered accounting firms outside of the United States located in more than 80 countries. Working effectively with the PCAOB's counterparts in other countries is an important component of meeting this challenge. Since the establishment of the PCAOB, independent auditor oversight systems have begun to emerge around the world. The establishment of these systems in other countries where there are PCAOB-registered firms provides greater potential for coordination even when regulators have differing oversight regimes and requirements. The Board has made it a priority to enhance the PCAOB's coordination with our international counterparts and expand the PCAOB's role in efforts to improve auditor oversight and auditing practices worldwide. During 2006, the PCAOB expanded its participation in cross-border information-sharing and coordination with audit regulators. I am confident that the PCAOB can work with other audit oversight bodies on a multilateral and bilateral basis to minimize the burdens of duplicative or contradictory regulation at the same time that we fulfill our important statutory obligations to investors and the public.

The mission of the PCAOB under the Act is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. I believe that we are making real progress in achieving the mission's objectives. I also believe that the PCAOB is contributing to a reduction in the risk of financial reporting failures and to a renewed confidence in the financial reports of public companies in the U.S. securities markets. With a seasoned Board and talented staff, the PCAOB is well-positioned to continue its important work. I look forward to meeting the challenges of 2007 and beyond.

Mark W. Olson

Mark W. Olson
Chairman
Public Company Accounting Oversight Board

Overview

During its fourth year of operations, the PCAOB continued to build and further refine its statutory programs, while operations matured toward a more steady state and size. The PCAOB continued to fulfill its Congressional mandate to protect investors through the oversight of registered accounting firms, utilizing a supervisory model that integrates its registration, inspection, standards-setting, enforcement and support functions.

The PCAOB's standards and rules establish a regulatory framework for inspecting registered firms. The inspection process, however, goes beyond measuring compliance and assesses the quality control environment of the registered firms. The Board strives at all levels to maintain constructive, arms-length dialogue with registered firms, and the remediation of identified deficiencies is an important part of this dialogue. This approach encourages a culture of integrity and rigor within the profession, while allowing the PCAOB to retain all of the formal and informal tools necessary to identify problems early on, require improvements, or, in more serious cases, take disciplinary action.

Importantly, information-sharing across PCAOB program areas is providing insights on emerging risks in the auditing profession and developments regarding specific audit practices. These insights are enabling the PCAOB to be more adept in focusing its supervisory activities and further shaping the PCAOB's outreach to investors, audit firms, and other stakeholders.

From the viewpoint of public investors, the most important feature of the supervisory model is its prudential aspect: the PCAOB's programs are resulting in stronger quality control and risk-management practices of registered firms and broader, more consistent compliance with applicable professional standards. This should contribute to public confidence in the reliability and independence of audit reports, an important goal for the PCAOB under the Act. Audit firms are realigning their business models to focus on quality audit services, ethics, and appropriate levels of independence. This, in turn, should have a positive effect on the stability of the auditing firms that serve public companies.

In 2006, PCAOB inspection teams completed their third full inspection of all U.S. registered accounting firms with more than 100 public company audit clients, their second round of inspections of the audits of internal control by these firms, and continued their program of triennial inspections of other firms with issuer audit clients. During this period, PCAOB inspectors inspected 172 registered accounting firms located in the United States and in seven other countries. Inspections staff issued reports on 206 firms that were inspected in 2004, 2005, and 2006. Where deemed appropriate, the Board brought disciplinary actions against certain registered accounting firms and auditors at those firms.

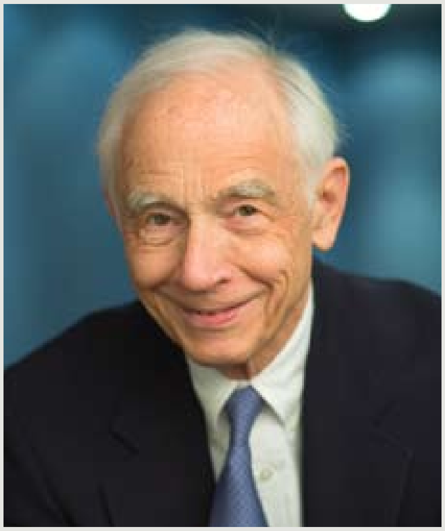
During 2006, the Board continued to expand its activities in the international arena. The PCAOB held discussions regarding cooperation with approximately 20 countries worldwide, thereby facilitating the Board's inspection work in Canada, Asia, Latin America, and the European Union and setting the groundwork for 2007 inspections elsewhere. The Board expects that these discussions and inspections will continue to expand in 2007 as the PCAOB works with non-U.S. regulatory bodies to coordinate resources, reduce unnecessary regulatory burdens, and promote strong and constructive auditor oversight in order to better protect U.S. investors and investors worldwide.

For many public companies and their auditors, 2006 was the second year of reporting to meet the requirements of section 404 of the Act regarding companies' internal control over financial reporting. During 2006, the PCAOB continued to monitor the impact of AS No. 2 on auditors and issuers and undertook a number of significant initiatives to clarify and simplify the auditing of internal control by regulated audit firms. Most importantly, in December 2006, the Board proposed a set of proposals to supercede AS No. 2.

The PCAOB's outreach efforts throughout 2006 involved discussions with a wide range of interested groups about PCAOB auditing standards, as well as inspections, international oversight, enforcement, and corporate governance matters related to the auditor/audit client relationship. One of the Board's targeted efforts to obtain and share information on its work involved continuing a series of meetings with auditors, directors, and financial executives of smaller public companies—the Forum on Auditing in the Small Business Environment. In addition, Board members and senior staff participated in numerous outreach meetings with these and other stakeholders and gave almost 200 speeches across the country and around the world. In March 2006, Acting Chairman Bill Gradison testified before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises concerning accuracy, transparency, and complexity in financial statements. In September 2006, Chairman Mark Olson testified before the Senate Banking Committee regarding the PCAOB's response to concerns related to certain stock option granting practices, and to the House Financial Services Committee concerning protecting investors and strengthening capital markets four years after the Act.

The PCAOB also maintained a dialogue with other U.S. and non-U.S standards-setting bodies, including the Financial Accounting Standards Board (FASB), the National Association of State Boards of Accountancy (NASBA), the Government Accountability Office (GAO), and the International Auditing and Assurance Standards Board (IAASB). In addition, the PCAOB continued to dialogue with its auditor oversight counterparts internationally, including through the International Forum of Independent Auditor Regulators (IFIAR), which was formally established in 2006.

The Act gives the SEC oversight authority over the PCAOB. This authority includes the responsibility to appoint Board members of the PCAOB after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. Board members include Kayla J. Gillan, Daniel L. Goelzer, Charles D. Niemeier, and Bill Gradison, who was appointed Acting Chairman by the SEC on December 2, 2005. On July 5, 2006, Mark W. Olson joined the PCAOB as Chairman of the Board, bringing the Board to its full complement.



"Congress created the PCAOB 'to protect investors'—not issuers, not management, and not auditors, but the owners of public companies. In my judgment, we've made considerable progress in doing what the law directs us to do."

Bill Gradison, Board Member

The Sarbanes-Oxley Act of 2002 and the Board's rules prohibit accounting firms that are not registered with the Board from preparing or issuing audit reports on U.S. public companies or from playing a substantial role in these activities. Registered firms are subject to the Board's oversight, including its inspections and enforcement authority.

Registration

Registration of accounting firms provides the foundation for the PCAOB's inspections and enforcement activities. The Act and the Board's rules prohibit accounting firms that are not registered with the PCAOB from preparing or issuing audit reports on U.S. public companies or from playing a substantial role in such activities. Additional accounting firms have continued to seek registration with the PCAOB. During 2006, the Board approved 196 registration applications and 48 withdrawal applications, bringing the total number of registered firms to 1,738 at year-end.

Registered firms have diverse characteristics, and the Board has tailored its oversight programs to the firms that have registered. The firms vary according to geographic location and size. For example, 752 (43 percent) of the firms registered with the Board at the end of 2006 were based outside the United States in a total of 82 countries. In addition, 537 (31 percent) of the firms that were registered at the end of 2006 reported one to five issuer audit clients, and 976 (56 percent) of the firms registered at the end of 2006, including 444 (26 percent) in the United States, reported no issuer clients at the time they applied for registration.

In May 2006, the Board proposed rules to establish a periodic reporting framework for registered public accounting firms. The proposed rules would require registered firms to report certain current and annual information. This information would be used in part to inform the PCAOB's other supervisory activities.

NUMBER OF REGISTERED FIRMS BY COUNTRY

(as of 12/31/06)

COUNTRY	NUMBER OF REGISTERED FIRMS
United States	986
China	68
United Kingdom	64
Canada	54
Australia, India	36
Germany	32
France	31
Singapore	20
Brazil	17
Mexico	16
Israel, South Africa	15
Spain	14
Belgium, Italy, Japan, Netherlands	13
New Zealand, Republic of Korea, Taiwan, Turkey	12
Argentina, Ireland, Malaysia	11
Russian Federation	10
Indonesia, Switzerland	8
Austria, Colombia, Philippines, Thailand, Venezuela	7
Chile, Czech Republic, Hungary, Norway, Poland, Portugal, Romania, Sweden	6
Costa Rica, Denmark, Finland, Greece, Peru	5
Bermuda, Cayman Islands, Kazakhstan, Luxembourg, Panama	4
Bolivia, Egypt, Pakistan, Ukraine	3
Bahrain, Cyprus, Iceland, Malta, Paraguay, Slovakia, Slovenia	2
Armenia, Bahamas, Belize, Brunei Darussalam, Bulgaria, Cambodia, Croatia, Dominican Republic, El Salvador, Estonia, Georgia, Ghana, Haiti, Lao People's Democratic Republic, Lebanon, Mauritius, Papua New Guinea, Tunisia, United Arab Emirates, Uruguay, Vietnam	1
TOTAL	1,738

International

To the extent that a public accounting firm's practice includes auditing, or playing a substantial role in auditing, financial statements that are filed in the United States, the Act subjects the firm to the registration requirements and the PCAOB's oversight, regardless of where the firm is located. To carry out this oversight responsibility, the Board adopted rules setting forth a cooperative model that allows the PCAOB to rely, if the Board deems appropriate and to varying degrees, on inspection or enforcement work performed by a home-country regulator. The Board's oversight rules also provide for the PCAOB to assist non-U.S. regulators in inspections and investigations of U.S. firms subject to dual oversight.

During 2006, the PCAOB continued to establish effective working relationships with its non-U.S. counterparts and develop cooperative arrangements for the oversight of non-U.S. registered firms. The PCAOB had contact or discussions regarding cooperation with several countries, including Argentina, Australia, Brazil, Canada, Chile, France, Germany, India, Ireland, Israel, Japan, Korea, Mexico, the Netherlands, Norway, South Africa, Sweden, Switzerland, and the United Kingdom. These discussions facilitated the PCAOB's inspections of registered non-U.S. firms in Asia, the European Union, Israel, and Latin America. The PCAOB also continued its cooperative arrangements with Canada (the PCAOB's most significant non-U.S. jurisdiction in terms of number of firms registered and market capitalization of the public companies audited by those firms) and the United Kingdom. As a result, the PCAOB was able to conduct joint inspections of PCAOB-registered firms in those jurisdictions with the home country audit regulator. In addition, through coordination with relevant government agencies, the PCAOB initiated PCAOB inspections in five other countries that do not currently have independent auditor oversight bodies that regularly conduct inspections.

During the year, the PCAOB had very productive discussions with the European Commission (EC) and continued to work with the EC with regard to the implementation of the European Union's new 8th Company Law Directive. The PCAOB also began discussions with the EC on a plan or "roadmap" for future cooperation among the PCAOB and the European Union Member States. Work on the roadmap discussions will continue into 2007.

In 2006, the PCAOB continued to act on its commitment to take a leadership role in improving worldwide auditor oversight and auditing practices. In October, the PCAOB announced that it would increase its level of participation in IFIAR, a new organization of the world's independent auditor regulators. In addition, the Board supported efforts by non-U.S. regulators and various professional bodies to continue to develop high-quality professional standards for auditing. The PCAOB participates as an observer, with speaking rights, at meetings of the IAASB and meets periodically with other national standards-setters. Reciprocally, the IAASB participates as an observer at meetings of the Board's Standing Advisory Group. The Board believes that encouraging greater international dialogue can help reduce unnecessary regulatory burdens on global accounting firms, without undermining the PCAOB's mission to protect investors and the public.

"The PCAOB's goal is to identify risks at an early stage and address them before they become major problems, instead of addressing problems only after they occur. Our Office of Research and Analysis, which synthesizes and analyzes available data, both from external and internal sources, is key to achieving this goal."

Charles D. Niemeier, Board Member

In 2006, the team leaders conducting large-firm inspections had an average of 25 years of relevant experience, and all other inspection team members averaged more than 14 years of relevant experience.

Inspections

The Act requires the Board to conduct annual inspections of registered accounting firms that audit more than 100 public companies. Under the Act, other firms that regularly audit public companies are required to be inspected at least once every three years. The Board also has the authority to conduct special inspections as it deems appropriate.

PCAOB inspection teams are located across the United States in regional offices located in Atlanta, Chicago, Dallas, Denver, New York City, Orange County, San Francisco, and Washington, D.C. The teams are composed of experienced accountants. In 2006, the team leaders conducting large-firm inspections had an average of 25 years of relevant experience, and all other inspection team members averaged more than 14 years of relevant experience.

In 2006, the PCAOB inspected 172 registered accounting firms. Of those firms, nine audited more than 100 public companies: the eight largest U.S. accounting firms and one Canadian firm. The other firms inspected in 2006 included 149 U.S. firms and 14 non-U.S. firms located in seven countries, each of which audits 100 or fewer public companies. PCAOB inspectors conducted PCAOB "office-based" inspections of 37 firms in 2006, whereby the examination of certain smaller firms' audit work papers occurred at the PCAOB offices rather than at the accounting firms' offices. This approach helps to conserve PCAOB resources and minimize the inspection burden on smaller firms.

Inspection Process

As part of the PCAOB's inspection process, inspectors review portions of selected audit engagements of registered accounting firms. In 2006, PCAOB inspectors reviewed portions of more than 360 audits performed by the largest nine firms and 720 audits performed by 163 smaller firms. Engagements, as well as the portions of engagements, are selected for inspection primarily based on an assessment of the risk of material misstatement of the financial statements or significant auditing deficiencies, as well as other firm-specific risks.

When PCAOB inspectors find potential departures from generally accepted accounting principles (GAAP), errors, or significant auditing deficiencies in the audit of public company financial statements reviewed during the inspection, they invite the auditing firm to comment on the accounting and auditing work involved. This process not only helps to verify the PCAOB's assessments, but it also helps the firm to identify the causes and scope of the problem.

Throughout this process, inspectors discuss identified problems with representatives of the firm, including members of the relevant engagement team, the representative responsible for the firm's handling of the inspection, the firm's national office experts, and, in some cases, the managing partner or chief executive of the firm. Significant problems are ultimately described in Board inspection reports. Even before reports are issued, however, inspectors' discussions with firms often result in problems being immediately addressed by the firms. This may involve performing missed auditing procedures, enhancing internal quality control requirements, discussing the problem with the audit client involved, and other actions. In some instances, following discussions with their auditors, public companies may issue restated financial statements as a result of potential GAAP issues identified by the inspection team.

Inspection Reports

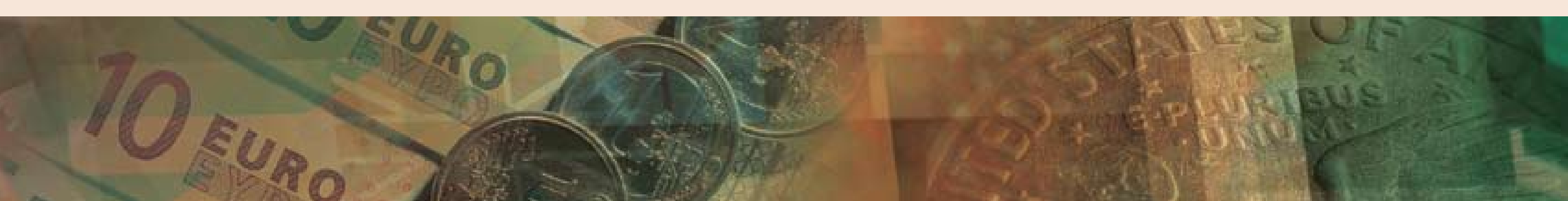
During 2006, the Board issued 206 reports on inspections conducted in 2004, 2005, and 2006. As provided in the Act, the Board releases portions of its reports publicly. The public portions, which are posted on the PCAOB's Web site, summarize significant auditing deficiencies found in the inspection.

The Act limits the public availability of certain information obtained in the inspection process, including portions of inspection reports dealing with a firm's quality control systems. The Act specifically provides that identified quality control deficiencies are made public only if, after 12 months, the firm has failed to address and remediate the deficiencies to the Board's satisfaction. This reflects a legislative policy choice encouraging self-correction and is a cornerstone of the PCAOB's supervisory oversight model.

Remediation Process

On March 21, 2006, the Board issued two releases related to remediation. One of the releases related to observations on the initial implementation of the remediation process by the four largest accounting firms following limited inspections of these firms in 2003. The PCAOB's findings supported the legislative hypothesis that firms could be genuinely motivated by the prospect of keeping the Board's quality control criticisms confidential when firms took appropriate steps to remediate quality control deficiencies within 12 months of a Board report describing deficiencies.

The second release related to the process for Board determinations regarding firms' efforts to address quality control deficiencies in inspection reports. The inspection staff is proactive in providing firms with the opportunity to discuss inspection findings. PCAOB inspectors engage in dialogue with registered accounting firms so that firms can receive timely feedback from PCAOB staff and thereby enhance their efforts to address quality control deficiencies. Firms are required to make a submission pursuant to PCAOB Rule 4009 explaining how the firm has adequately addressed an inspection report's quality control deficiencies in order to prevent the deficiencies from becoming public. During 2006, PCAOB inspectors continued to perform assessments of Rule 4009 submissions and, based on these assessments and any dialogue between the firm and the inspectors, provided recommendations to the Board. The Board considered these recommendations and made determinations as to whether the firms had demonstrated substantial, good faith progress toward achieving the relevant quality control objectives, sufficient to merit the result that the criticisms remain nonpublic. If a firm fails to make a submission or the Board finds that a firm has not made sufficient progress in remediating quality control deficiencies, and the firm has not sought SEC review within 30 days of the Board's determination, the quality control portion of the firm's inspection report is made available on the PCAOB's Web site.



Inspections of Internal Control Over Financial Reporting

On May 1, 2006, the Board issued a *Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle*. This statement describes the approach to inspections of audits of internal control over financial reporting (ICFR) for the 2006 inspection cycle at the eight largest U.S. accounting firms that are inspected annually. Consequently, PCAOB inspectors focused on progress being made by firms in implementing the Board's guidance on achieving the ICFR audit objectives. Specifically, the inspectors evaluated: (1) the degree of integration between the ICFR audit and the audit of the financial statements, (2) the use of a top-down approach, (3) the proper assessment of and response to identified risks, and (4) the use of the work of others.

ICFR inspection activities were conducted at three levels: (1) meetings with senior firm leadership, (2) firm national office inspection procedures, and (3) engagement inspection procedures for audits of accelerated filers. During 2006, discussions with senior firm leadership focused on the extent to which the firm's strategy supported implementation of the Board's guidance on audits of internal control. National office procedures focused on whether a firm's forms, methodologies, and training were designed to enable the firm to implement the guidance in the four areas. Finally, the engagement-level procedures focused on whether the engagement team realized efficiencies in the four areas. Feedback from ICFR inspection activities was provided to senior firm leadership throughout and at the conclusion of the inspection process.

RESEARCH AND ANALYSIS

Research and analysis staff collects, maintains, and analyzes information from multiple sources in order to facilitate the PCAOB's risk-based oversight of registered public accounting firms. The staff performing these functions also gathers information that is useful in assessing the nature and magnitude of the impact of PCAOB activities on investors, issuers, and audit firms. These functions require highly experienced personnel with backgrounds in accounting and auditing, economics, finance, and information management to enable the PCAOB to achieve its goals.

The PCAOB's primary research and analysis focus is to identify and measure emerging accounting and auditing issues and other key areas of risk that might contribute to audit failures. To this end, research and analysis staff collects and uses a wide variety of both publicly available and non-public information. Data collection and analysis across the inspections, enforcement, and standards-setting program areas are critical to the PCAOB, and the PCAOB will continue to refine tools for such collection and analysis moving forward.

In 2006, PCAOB's research and analysis efforts were committed substantially to identifying and assessing the risk of undetected material misstatements in audited financial statements of issuers. These assessments were used in conjunction with other information to directly support risk-based inspections and enforcement activities.

Staff research may identify audit risks that are appropriate to communicate directly to registered audit firms. In 2006, with the assistance of the PCAOB's standards-setting staff, the Board's research and analysis staff issued Audit Practice Alert No.1, *Matters Related to Timing and Accounting for Option Grants,* to all registered public accounting firms. This Alert provides firms with guidance on assessing the likelihood of material errors in financial statements resulting from matters related to the timing and accounting for stock option grants. Audit practice alerts are intended to inform registered firms of risks that may impact their work arising from new or otherwise noteworthy conditions or circumstances, within the context of existing standards for auditing and accounting.

The PCAOB devoted considerable effort in 2006 to implementation issues related to the internal control provisions of Sections 103 and 404 of the Act.

Auditing and Related Professional Practice Standards

The PCAOB devoted considerable effort in 2006 to implementation issues related to the ICFR provisions of Sections 103 and 404 of the Act, which require auditors to examine the effectiveness of, and attest to management's assessment of, ICFR. The PCAOB also issued guidance, in the form of staff questions and answers, for auditing the fair value of share option grants to employees and for adjustments to prior-period financial statements that were audited by a predecessor auditor.

Internal Control over Financial Reporting

For many public companies and their external auditors, 2006 was the second year that they were required to meet the compliance requirements set by the SEC and the PCAOB to implement the internal control requirements of the Act. Because of the importance of, and costs associated with, auditors issuing reports based on their application of AS No. 2, the PCAOB undertook a number of initiatives to both collect feedback and improve implementation.

On May 10, 2006, the Board and the SEC heard from public companies, auditors, investors, and others at a roundtable on second-year implementation experiences with AS No. 2. While most of the participants noted that the requirements produced benefits, including additional focus on internal control by corporate management, many participants also noted unnecessary costs related to the requirements. The Board and the SEC responded by announcing, on May 17, 2006, plans to improve implementation of internal control reporting requirements.

For its part, the Board announced a four-point plan that involves amending AS No. 2, reinforcing auditor efficiency through PCAOB inspections, developing or facilitating the development of implementation guidance for auditors of smaller public companies and exploring various opportunities for such auditors to obtain effective training on auditing ICFR, and continuing the PCAOB Forums on Auditing in the Small Business Environment.

On December 19, 2006, the Board published for comment proposals to improve the implementation of internal control reporting. These proposals, which would supersede AS No. 2, include two new standards. The first, *An Audit of Internal Control over Financial Reporting That is*

Integrated with an Audit of Financial Statements, would focus the audit of internal control on the most important matters, emphasize risk assessment concepts to direct the auditor to the high-risk areas, eliminate procedures unnecessary to achieving the intended benefits, provide direction on scaling the audit to fit the size and complexity of the public company, and simplify the text of the standard. The Board hopes that the proposed changes will eliminate unnecessary requirements while preserving the principles of AS No. 2. The second proposed standard, *Considering and Using the Work of Others in an Audit,* is intended to clarify how an independent auditor may use the work of others to reduce the work the auditor would otherwise have to perform. Taken together, the proposals are intended to reduce compliance burdens without diminishing the substantial benefits investors have received from improved internal control over financial reporting since the adoption of AS No. 2. Also included in the proposed package is proposed Rule 3525—*Audit Committee Preapproval of Services Related to Internal Control over Financial Reporting,* which would replace direction currently contained in AS No. 2 regarding independence and internal control-related services and would ensure that audit committees are provided relevant information to enable them to determine if the performance of internal control services by the auditor would impair the auditor's independence. Finally, the proposals would provide for certain amendments to the Board's interim standards.

The proposals were developed in coordination with the SEC, which proposed its own risk-based guidance for public companies in December 2006. The Board's proposed package of rule-making on internal control provided for a 70-day comment period ending on February 26, 2007. Final rules must be submitted to the SEC and will only be effective upon SEC approval.

In addition, during 2006, standards-setting staff undertook a collaborative project to develop implementation guidance for auditors of smaller public companies. Representatives from 12 registered accounting firms with experience implementing the internal control reporting requirements for smaller public companies are participating in this effort. The Board expects to issue this guidance in 2007.

"Setting auditing standards is a complex job. In addition to drawing on the experience and expertise of the Chief Auditor's staff, the Board works with its Standing Advisory Group to make sure that we have access to a wide range of perspectives on standards-setting priorities and objectives."

Daniel L. Goelzer, Board Member

Staff Questions and Answers

On June 9, 2006, the PCAOB published staff questions and answers to provide guidance to auditors with regard to adjustments to prior-period financial statements that were previously audited by another auditor. Statement of Financial Accounting Standards No. 154 (SFAS 154), *Accounting Changes and Error Corrections,* requires that all voluntary changes in accounting be applied retrospectively to all prior periods presented in the financial statements, unless it is impracticable to do so. The previous accounting standard required that most voluntary changes be accounted for in the period of the change. With the adoption of SFAS 154, questions are more likely to arise as to which auditor—the newly appointed auditor or the previous auditor—can audit and report on retrospective adjustments made by a company.

On October 17, 2006, the PCAOB published staff questions and answers about auditing the fair value of share options granted to employees. The staff guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to SFAS No. 123 (Revised). This statement became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

Standing Advisory Group

The Board met three times in 2006 with its Standing Advisory Group (SAG)—a diverse body of stakeholders established by the Board to provide advice regarding auditing and professional practice standards. The group consists of 31 individuals with expertise in a variety of fields, including accounting, auditing, corporate finance, corporate governance, and investing. Six organizations have observer status with speaking rights at all meetings of the SAG. Those six organizations are the SEC, the FASB, the GAO, the IAASB, the U.S. Department of Labor (DOL), and the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA).

The group's 2006 meetings were open to the public and broadcast through the PCAOB's Web site to make the discussions available to as wide an audience as possible. The agenda for each meeting was accompanied by publicly available briefing papers on the topics to be discussed.

At the February 9, 2006 meeting, the group discussed the use of specialists in audits, risk assessment in financial statement audits, and emerging issues. On June 12 and 13, 2006, the group convened in a meeting that devoted significant time to issues related to audits of internal control, including possible changes to AS No. 2 being considered by the staff. The group heard from panels of auditors and issuers about their experiences with audits of internal control. The group also heard from a panel of academics regarding their synthesis of academic research relevant to PCAOB standards-setting projects and discussed emerging issues.

In the final meeting of the year, on October 5, 2006, as part of the Board's strategic planning process, the group discussed certain success factors to enable the PCAOB to achieve its mission under the Act. The group also discussed smaller public company/smaller firm challenges (including hearing from a panel). In addition, the PCAOB sought advice from the group on priorities for auditing and related professional practice standards. Among the topics that the staff presented were:

- Revision of AS No. 2;
- Principles of reporting (to address SFAS No. 154 and the GAAP hierarchy);
- Engagement quality review;
- Risk assessment, including fraud risk assessment;
- Related parties, including considerations of fraud risk factors;
- Confirmations, including consideration of fraud risk factors; and
- Fair value, including the use of specialists.

Investigations and inquiries arise from a number of sources, including PCAOB inspections of registered firms, PCAOB research and analysis, other regulators, public disclosures of restatements and auditor changes, news reports, and confidential tips.

Enforcement and Investigations

The PCAOB is authorized by the Act to investigate auditor conduct that may violate the laws, rules, or standards within its jurisdiction. The Board is empowered to impose a range of disciplinary sanctions against registered accounting firms and associated persons who violate those laws, rules, or standards.

The PCAOB's investigatory staff conducts informal inquiries as well as formal investigations. An informal inquiry is a preliminary fact-finding process. In informal inquiries, the staff may request documents, information, or testimony from any person. When the Board authorizes a formal investigation, the staff may demand that any registered firm and associated person provide sworn testimony or documents relevant or material to an investigation.

Investigations and inquiries arise from a number of sources, including PCAOB inspections of registered firms, PCAOB research and analysis, other regulators, public disclosures of restatements and auditor changes, news reports, and confidential tips. To encourage a flow of useful information, the PCAOB maintains an online "PCAOB Center for Enforcement Tips, Complaints, and Other Information," as well as a hotline number.

Investigations may lead the Board to institute disciplinary proceedings, which carry the prospect of a range of sanctions, from requiring additional professional training to more severe penalties, including significant money penalties and the possible revocation of a firm's registration or bar of an associated person.

The PCAOB's investigations are, by law, confidential and nonpublic. Pursuant to the Act and the Board's rules, however, the enforcement staff works closely with the SEC's Division of Enforcement to coordinate many of its investigations. In appropriate circumstances, the Act provides that information gathered in PCAOB investigations may also be shared with the U.S. Department of Justice, certain federal banking regulators, state attorneys general, and appropriate state regulatory authorities.

In 2006, the staff initiated a number of informal inquiries and, with Board approval, eight formal investigations of registered firms and associated persons. In addition, the Board publicly announced settled disciplinary proceedings against three registered firms and three associated persons. In one of the actions, the Board revoked a registered firm's registration and barred its two partners from being associated persons of registered firms on the basis of its findings that the firm and its partners engaged in "intentional or knowing conduct, including reckless conduct" that resulted in violations of PCAOB rules and auditing standards in auditing the financial statements of four public company clients. The Board's order states that after two years, the firm may reapply for registration with the Board, and the partners may file petitions for Board consent to associate with a registered firm.

In another action, the Board barred a partner of a registered firm and censured the registered firm on the basis of its findings that the associated person engaged in "intentional or knowing conduct, including reckless conduct" that resulted in violations of PCAOB rules and auditing standards in auditing the financial statements of a public company client. The Board order states that after two years, the partner may file a petition for Board consent to associate with a registered firm. In the third action, the Board censured another registered firm for violating the securities laws by failing to take prompt and appropriate steps in response to indications that a public company client may have committed an illegal act.

The Board's orders in these cases are posted on the PCAOB's Web site.

"Proactively seeking input from our stakeholders is vital to the PCAOB's success. It is not enough for the Board to only listen to those who have become so concerned that they approach us. We must reach out to those impacted by our work and ask for their views, hopefully before interest turns into concern."

Kayla J. Gillan, Board Member

PCAOB FORUMS ON AUDITING IN THE SMALL BUSINESS ENVIRONMENT

Conceived in 2004 in response to concerns about the effects of the Act and the impact of the Board's rules on smaller registered accounting firms and smaller public companies, the Forum is an ongoing program to share information on the PCAOB's work and to obtain feedback from the small business community. During 2006, the PCAOB held eight forums around the country for auditors of smaller public companies. Four of the meetings included a separate session for directors and financial executives of smaller public companies. Each forum provided participants with the opportunity to hear key messages from individual Board members, as well as in-depth analysis of the critical findings from the PCAOB's small audit firm inspection program. New and proposed auditing standards were also described and discussed. Importantly, participants had the opportunity to provide timely and relevant feedback directly to the PCAOB. This feedback significantly influenced the Board's analysis of, and response to, comments and suggestions received from a broader audience regarding the impact of the Board's work on this unique sector of the U.S. economy.

Since the inception of the small business forums in late 2004, almost 2,000 members of the small business community have attended the forums. In 2006, over 500 auditors from small firms attended one of the eight forums conducted for auditors and over 125 audit committee members and financial executives from smaller public companies attended one of four sessions designed to address specific questions and concerns from the small business community. Evaluations provided by attendees indicated that the sessions were "comprehensive," "real life/practical," and "in plain English and focused on current events." Given the positive feedback the Board received, the program will be held in eight cities in 2007.

During 2006, internal oversight and performance assurance staff completed a series of reviews that focused on the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls.

Internal Oversight and Performance Assurance

The PCAOB's Office of Internal Oversight and Performance Assurance (IOPA) provides the Board assurance with respect to the quality, accountability, and operational efficiency of PCAOB programs and operations. IOPA conducts performance reviews of PCAOB programs and operations, provides real-time quality assurance assessments to the Board, and may also receive and review allegations of wrongdoing by PCAOB employees.

IOPA conducts its performance reviews in accordance with the GAO's *Government Auditing Standards* (the Yellow Book). During 2006, IOPA completed a series of reviews that focused on the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls. IOPA conducted a risk assessment of the Board's information technology (IT) activities and conducted related follow-up reviews, which led to the issuance of three IT-related reports. In 2006, IOPA issued reports reflecting reviews of the Board's Office of the Chief Auditor, Division of Enforcement and Investigations, Office of Research and Analysis, IT investment review process, document management process, and enterprise architecture project. Summaries of these reviews are posted on the PCAOB's Web site.

Financial Review

During its fourth year of operation, the PCAOB continued to build and further refine its statutory programs while operations matured toward a more steady-state and size.

Each year, the PCAOB develops a budget that must be approved by the Securities and Exchange Commission, as required by the Sarbanes-Oxley Act of 2002. On November 22, 2005, the Board adopted a 2006 budget of approximately $128 million, that was approved by the SEC on April 13, 2006.

STATEMENTS OF FINANCIAL POSITION

The PCAOB financial statements have been prepared in accordance with GAAP and are presented pursuant to *Statement of Financial Accounting Standards* SFAS No. 117, Financial Statements of Not-for-Profit Organizations (SFAS No. 117). In accordance with SFAS No. 117, the net assets of the PCAOB are not subject to restrictions, and, therefore, all have been classified as unrestricted in the financial statements. The PCAOB's unrestricted net assets decreased by approximately $14 million in 2006. As part of the 2006 budget, the PCAOB reduced the 2006 accounting support fee by $19 million, which decreased the amount of cash received from issuers in 2006 resulting in a decrease of net assets. The PCAOB's unrestricted net assets for 2005 and 2006 primarily consist of amounts to fund operations in the subsequent year prior to collection of that year's accounting support fees and the organization's investments in fixed assets, particularly technology hardware and software.

Cash and Cash Equivalents

Cash and cash equivalents include demand deposits with financial institutions and short-term, highly liquid investments. The PCAOB utilizes a sweep service from a financial institution to invest daily in overnight repurchase agreements, typically in U.S. Treasury or agency issues.

Cash and cash equivalents also include cash collected on behalf of the FASB. The Financial Accounting Foundation designated the PCAOB as the collection agent for invoicing and collecting the 2004–2006 FASB accounting support fees, as authorized by the Act. The cash and cash equivalents include approximately $7,000 and $67,000 of cash collected on behalf of the FASB at December 31, 2006 and 2005, respectively. Corresponding amounts were included in accounts payable and other liabilities in 2006 and 2005. The PCAOB earned and was paid approximately $209,000 in both 2006 and 2005 from FASB in its capacity as a billing and collection agent for FASB's support fees.

Short-Term Investments

In June 2005, the PCAOB began investing in U.S. Treasury bills in order to earn additional yield on its cash balance. The Board had approximately $61 million and $53 million invested in Treasury bills as of December 31, 2006 and 2005, respectively.

Accounts Receivable

Accounts receivable consist of PCAOB's accounting support fees from public companies. The PCAOB collected approximately 99.9 percent of accounting support fees in 2006 and 2005. As a result, accounts receivable related to accounting support fees from public companies were $44,000 and $45,000 as of December 31, 2006 and 2005, respectively.

Prepaid Expenses and Other Assets

Prepaid expenses and other assets, which were approximately $2.8 million and $2.3 million at December 31, 2006 and 2005, respectively, consist primarily of cash paid in advance for rent, insurance, software maintenance contracts, and data and media subscriptions. The increase in prepaid expenses and other assets was primarily due to an increase in prepaid expenses for software maintenance agreements and rent related to the New York office relocation.

Furniture and Equipment, Leasehold Improvements, and Technology

During 2006 and 2005, the PCAOB invested approximately $4.6 million and $14.2 million, respectively, in furniture and equipment, leasehold improvements, and information technology to continue to build the infrastructure of the organization. The decrease in investment is largely attributable to a significant decrease in spending on the organization's infrastructure. By December 31, 2006, the PCAOB had established its Washington, D.C. headquarters and seven regional offices in New York City, Atlanta, Chicago, Dallas, Denver, Orange County, and San Francisco, and a Northern Virginia office for its information technology group.

The PCAOB's investment in technology, furniture, and leaseholds reflects the development of a stable operational infrastructure, telecommunications, security, and software. Technology development in process represents capital expenditures that have been capitalized but not depreciated as of the end of 2006 because the assets had not been placed in service. It is anticipated that these assets will be placed in service during the first half of 2007. The following chart reflects capital expenditures for 2006 and 2005:

Capital Expenditures
(as of 12/31/06)

	2006	2005
Technology—program activities	$ 671,000	$ 1,660,000
Technology—supporting activities	1,585,000	4,110,000
Furniture and leasehold improvements	1,842,000	6,862,000
Technology development in process	490,000	1,599,000
Total	$4,588,000	$14,231,000

Accounts Payable and Other Liabilities

Accounts payable and other liabilities for both years are primarily made up of year-end accruals. The slight decrease in 2006 is attributable to normal operating fluctuations with regard to the receipt and payment of invoices.

STATEMENTS OF ACTIVITIES

Operating Revenue

The PCAOB's operations are funded by accounting support fees assessed annually on issuers based on a methodology described in the Act and PCAOB rules.

The accounting support fee, or "fees from issuers" as reflected in the financial statements, is equal to the Board's budget for the calendar year for which it is set, less the amount of fees received in the prior year from public accounting firms or "fees from registering accounting firms."

Under the Act and the PCAOB's rules, the annual accounting support fee is allocated to issuers based on the average monthly U.S. equity market capitalization of publicly traded companies, investment companies, and other equity issuers. However, issuers with average market capitalization of less than $25 million, and investment companies with net asset values of less than $250 million, are exempt from the fee.

In 2006, the PCAOB issued invoices to approximately 10,200 issuers, as compared to approximately 9,600 issuers in 2005. The increase in the number of issuers primarily is due to changes in market capitalization per issuer. The PCAOB recorded approximately $109.3 million and approximately $136.0 million in 2006 and 2005, respectively, in accounting support fee revenue. The decrease in accounting support fee revenue was primarily due to a $19.0 million reduction of the accounting support fee assessed to issuers that resulted from excess working capital at December 31, 2005.

In 2006, approximately 53 percent of the issuers received invoices for $1,000 or less, and the largest 1,000 issuers received invoices for approximately 83 percent of the total fees. The accompanying chart reflects the distribution of fee levels by issuers.

Assessment of Accounting Support Fees

	NUMBER OF ISSUERS	
FEES	2006	2005
$100–500	3,783	2,750
$501–1,000	1,612	1,565
$1,001–5,000	2,652	2,842
$5,001–10,000	796	906
$10,001–50,000	940	1,083
$50,001–100,000	187	201
$100,001–500,000	171	203
$500,001–1,000,000	21	29
$1,000,001+	9	14
Total	10,171	9,593

Combined, publicly traded companies contributed approximately 95 percent of the total fees invoiced in 2006, while open-end mutual funds provided about 4.3 percent, and other investment companies paid the remainder.

In addition to the annual accounting support fee, the Board receives registration fees from public accounting firms seeking to register with the Board pursuant to Section 102 of the Act and PCAOB rules. Accounting firms seeking to register with the Board are required to pay fees based on each firm's number of public company audit clients. The fees range from $250 for a firm with no public company audit clients to $390,000 for a firm with more than 1,000 public company audit clients.

In 2006, the PCAOB collected approximately $50,000 from registration applicants and approved the registration of 196 firms. In 2005, the PCAOB collected $66,000 from registration applicants and approved the registration of 244 firms.

Operating Expenses

Program Activities

The Act gives the PCAOB four primary responsibilities to carry out its mission: registration, inspections, standards-setting, and enforcement. These responsibilities are designated as program activities for the PCAOB and are so reflected in the financial statements. The financial statements continue to reflect two additional program activities. Research and analysis is designated as a program activity given its role in providing assessments of risks to the PCAOB's oversight programs, particularly inspections. Board and related activities reflect the Board and Board staff's activities, including the PCAOB's international initiatives.

Costs associated with program activities include salaries and benefits, rent, program-specific technology costs, and other direct operating expenses relating to a specific activity.

Registration and Inspections

During 2006, the PCAOB continued to register and inspect public accounting firms. The Board continued its efforts to recruit talented employees and invested in technology for inspections to support the PCAOB's inspection program.

The increase in program costs for registration and inspections from approximately $48.6 million in 2005 to approximately $63.0 million in 2006 primarily is related to the increase in inspections staff.

Enforcement

In 2006, the PCAOB continued to initiate formal and informal investigations of registered firms. The increase in program costs from approximately $5.0 million in 2005 to approximately $7.3 million in 2006 is directly related to the increase in salaries and benefits.

Standards-setting

During 2006, the standards-setting staff continued to assist the Board in its standards-setting process. During 2006, program costs of the office decreased slightly from approximately $4.0 million in 2005 to approximately $3.9 million in 2006.

Research and Analysis

The focus of the PCAOB's research and analysis is on identifying and measuring emerging accounting and auditing issues and other key areas of risk that might contribute to audit failures. The increase in program costs from approximately $5.3 million in 2005 to approximately $6.9 million in 2006 primarily is related to additional data and research expenses.

Board and Related Activities

Program costs were approximately $7.0 million in 2005 and approximately $7.4 million in 2006. In addition to discharging the Board's day-to-day responsibilities, the Board and its staff expanded outreach efforts domestically and internationally.

Supporting Activities

Supporting activities decreased from 35 percent of operating expenses in 2005 to 30 percent in 2006. These activities comprise three areas: administration and general; communications; and information technology.

Administration and General

Administration and general expenses include indirect costs relating to program activities in addition to operating costs for the following areas: administration, budget, finance, general counsel, human resources, and internal oversight and performance assurance. The costs for these areas slightly increased from approximately $13.9 million in 2005 to approximately $14.7 million in 2006. The increase in operating costs relates directly to an increase in staff and expenses related to outside legal counsel.

Communications

Communications includes the operating costs for the government relations and public affairs offices. The slight decrease of approximately $100,000 for these activities relates directly to a temporary decrease in staff.

IT Infrastructure, Security, and Telecommunications

Costs for IT infrastructure, security, and telecommunications include related salaries and benefits and depreciation associated with capital expenditures that are not directly attributable to program activities. Expenses decreased slightly from approximately $22.2 million in 2005 to approximately $21.7 million in 2006. The decrease resulted primarily from a transition from IT consultants to full-time employees.

Interest Income and Other

The increase in interest income from 2005 to 2006 is attributed to an increase in the average monthly cash balance and a higher yield in 2006. In addition, the PCAOB invested in U.S. Treasury bills for all of 2006 compared to a half-year for 2005.

Public Company Accounting Oversight Board

December 31, 2006

Report on Internal Control Over Financial Reporting

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles.

The Board is responsible for establishing and maintaining adequate internal controls over financial reporting. The PCAOB used the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in conducting our evaluation of the effectiveness of the internal control over financial reporting. Based on its evaluation, the Board concluded that the organization's internal control over financial reporting is effective as of December 31, 2006.

All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention or overriding of controls. Further, because of changes in conditions, the effectiveness of internal controls may vary over time. Projections of any evaluation of internal control effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate. Accordingly, even those systems of internal control determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Statements of Financial Position

	2006	2005
ASSETS		
Cash and cash equivalents	$ 7,952,124	$ 21,888,470
Short-term investments	61,459,350	52,645,119
Accounts receivable	43,740	44,672
Prepaid expenses and other assets	2,829,536	2,322,950
Furniture and equipment, leasehold improvements, and technology, net	19,819,726	27,525,674
Total Assets	$92,104,476	$104,426,885
LIABILITIES AND NET ASSETS		
Liabilities		
Accounts payable and other liabilities	$ 9,185,690	$ 9,757,210
Deferred rent	8,838,868	7,042,939
Total Liabilities	18,024,558	16,800,149
Unrestricted Net Assets	74,079,918	87,626,736
Total Liabilities and Net Assets	$92,104,476	$104,426,885

The accompanying notes are an integral part of the financial statements.

Public Company Accounting Oversight Board

December 31, 2006 and 2005

Statements of Activities

	2006	2005
Changes in Unrestricted Net Assets		
Operating revenue:		
Fees from issuers	$ 109,278,600	$136,005,200
Fees from registering accounting firms	49,750	66,000
Total operating revenue	109,328,350	136,071,200
Operating expenses:		
Program activities:		
Registration and inspections	63,029,855	48,580,410
Enforcement	7,287,041	5,044,595
Standards-setting	3,892,260	4,038,929
Research and analysis	6,887,292	5,327,626
Board and related activities	7,377,712	6,954,959
Supporting activities:		
Administrative and general	14,716,723	13,847,793
Communications	1,984,668	2,087,970
IT infrastructure, security, and telecommunications	21,654,729	22,165,962
Total operating expenses	126,830,280	108,048,244
Operating Income (Deficit)	(17,501,930)	28,022,956
Interest Income and Other	3,955,112	2,693,536
Increase (Decrease) in Unrestricted Net Assets	(13,546,818)	30,716,492
Unrestricted Net Assets—Beginning of Year	87,626,736	56,910,244
Unrestricted Net Assets—End of Year	$ 74,079,918	$ 87,626,736

The accompanying notes are an integral part of the financial statements.

Statements of Cash Flows

	2006	2005
Cash Flows from Operating Activities		
Cash received from issuers	$ 109,279,532	$ 135,993,982
Cash received from registering accounting firms	49,750	71,403
Interest income and other	3,955,112	2,693,536
Cash paid to suppliers and employees	(113,826,086)	(90,648,807)
Net cash provided by (used in) operating activities	(541,692)	48,110,114
Cash Flows from Investing Activities		
Purchases of furniture and equipment, leasehold improvements and technology	(4,587,623)	(14,231,001)
Proceeds from sale of furniture	7,200	—
Purchases of short-term investments	(170,679,781)	(152,105,921)
Proceeds from sales of short-term investments	161,865,550	99,460,802
Net cash used in investing activities	(13,394,654)	(66,876,120)
Net Decrease in Cash and Cash Equivalents	(13,936,346)	(18,766,006)
Cash and Cash Equivalents—Beginning of Year	21,888,470	40,654,476
Cash and Cash Equivalents—End of Year	$ 7,952,124	$ 21,888,470
Reconciliation of Increase (Decrease) in Unrestricted Net Assets to Net Cash Provided by (Used in) Operating Activities		
Increase (decrease) in unrestricted net assets	$ (13,546,818)	$ 30,716,492
Reconciliation adjustments:		
Depreciation and amortization	12,286,371	12,248,777
(Increase) decrease in accounts receivable	932	(5,815)
Increase in prepaid expenses	(506,586)	(1,213,124)
Increase (decrease) in accounts payable and other liabilities	(571,520)	2,863,815
Increase in deferred rent	1,795,929	3,499,969
Net Cash Provided by (Used in) Operating Activities	$ (541,692)	$ 48,110,114

The accompanying notes are an integral part of the financial statements.

Notes to the Financial Statements

NOTE 1—NATURE OF ACTIVITIES:

The Public Company Accounting Oversight Board (the PCAOB) was established by the Sarbanes-Oxley Act of 2002 (the Act) to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. The Act established the PCAOB as a private, non-profit corporation.

Under the Act, the PCAOB is overseen by the U.S. Securities and Exchange Commission (the SEC). The PCAOB's rules and standards are filed with the SEC and do not take effect unless approved by the SEC. In addition, the PCAOB's budget must be approved by the SEC, and the SEC must approve the PCAOB's bringing or defending litigation in any federal, state, or other court. Finally, the Act directs the SEC to appoint the members of the PCAOB's Board, after consultation with the chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, and gives the SEC authority, as appropriate, to rescind the PCAOB's Board authority and censure or remove individual PCAOB Board members.

NOTE 2—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Presentation. The financial statements have been prepared in accordance with U.S. generally accepted accounting principles and are presented pursuant to Statement of Financial Accounting Standards Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (SFAS No. 117). Under SFAS No. 117, the PCAOB is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. The net assets of the PCAOB are not subject to restrictions and therefore, all have been classified as unrestricted in the accompanying statements. The PCAOB's unrestricted net assets primarily consist of its investments in technology and amounts to fund operations in the subsequent year prior to collection of that year's funding. Registration and inspections, enforcement, standards-setting, research and analysis, and Board and related activities are the program activities for the PCAOB. Costs associated with these program activities include salaries, benefits, rent, program-specific technology costs, and other direct operating expenses relating to the above activities. Indirect costs are not allocated to program activities but are included in supporting activities.

Program Activities of the PCAOB:

- ***Registration and Inspections.*** The Act requires that an accounting firm be registered with the PCAOB if it prepares or issues, or plays a substantial role in the preparation or issuance of, any audit report with respect to an issuer. The PCAOB reviews the registration application of each public accounting firm that chooses to register with it. If the PCAOB approves its application, that registered public accounting firm is subject to the PCAOB's continuing program of inspections. This program assesses each firm's compliance with the Act, the rules of the PCAOB, and the rules of the SEC, as well as professional standards, in connection with the firm's performance of audits, issuance of audit reports, and related matters involving issuers, as defined in the Act.

- ***Enforcement.*** The Act grants the PCAOB broad investigative authority over registered public accounting firms and persons associated with such firms. The PCAOB has authority to impose disciplinary sanctions when it determines that one or more of the above has violated the laws, rules, or standards within the PCAOB's jurisdiction.
- ***Standards-setting.*** The PCAOB establishes auditing, related attestation, quality control, independence, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports.
- ***Research and Analysis.*** The PCAOB's Office of Research and Analysis collects, analyzes, and assimilates information from multiple sources and provides the PCAOB with assessments of risks that may influence public companies or their auditors to provide financial statements or other public information that is not fairly presented in all respects.
- ***Board and Related Activities.*** In accordance with the Act, the PCAOB Board is responsible for carrying out the PCAOB's regulatory programs and operations. Although the PCAOB Board has experienced professional staff in each of its program areas, the PCAOB Board remains responsible for determining the PCAOB's actions in each program area, as well as for performing such other duties or functions as the PCAOB Board (or the SEC, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and their associated persons, or otherwise to carry out the Act, in order to protect investors or further the public interest. In addition, the PCAOB Board engages in communication and other outreach efforts with the accounting profession, the investing public, public companies, and other U.S. and non-U.S. regulators concerning, among other things, the PCAOB's mission, programs, and initiatives and its oversight of the accounting profession. Also included in Board and related activities are the PCAOB's international initiatives.

Use of Estimates. The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and assumptions that may affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. Accordingly, actual results could differ from these estimates.

Fees from Issuers. Fees from issuers, which are referred to as the Board's accounting support fee in the Act, are amounts invoiced to certain issuers whose shares are publicly traded and to certain investment companies to fund the operating budget of the PCAOB. Such fees are recognized as revenue in the budget year to which they relate. The amount of fees invoiced to individual issuers is determined as prescribed in the Act and the Rules of the PCAOB. The PCAOB reports all fees from issuers as an increase in unrestricted net assets.

Fees from Registering Accounting Firms. Fees from registering accounting firms are amounts collected from each public accounting firm that applies for registration with the PCAOB to recover the costs of processing and reviewing registration applications. These fees are not intended to and do not cover certain registration program expenditures that do not relate solely to processing and reviewing registration applications. The PCAOB reports all fees from registering accounting firms as an increase in unrestricted net assets, and all such fees are recognized as revenue in the budget year to which they relate.

Cash Held for Others under Agency Agreement. On behalf of the Financial Accounting Standards Board (the FASB), the Financial Accounting Foundation (the FAF) designated the PCAOB as the collection agent for invoicing and collection of the 2006 and 2005 FASB accounting support fees. The PCAOB earned and was paid $209,400 in both 2006 and 2005 from the FAF for acting as the collection agent. This amount is included in interest income and other in the accompanying statements of activities. Otherwise, the PCAOB recognizes no revenue or expense related to this relationship and maintains a separate bank account for all fees collected on behalf of the FASB. As of December 31, 2006 and 2005, the PCAOB had $5,675 and $67,547, respectively, included in cash and cash equivalents related to the FASB. A corresponding $5,675 and $67,547 was included in accounts payable and other liabilities for amounts due to the FASB as of December 31, 2006 and 2005, respectively.

Cash and Cash Equivalents. The term cash and cash equivalents, as used in the accompanying financial statements, includes demand deposits with financial institutions and short-term, highly liquid investments purchased with a maturity of three months or less. At times, the PCAOB's demand deposits with financial institutions exceed federally insured limits. However, the PCAOB has not experienced any losses in such accounts, and management believes the PCAOB is not exposed to any significant credit risk on these accounts.

Short-term Investments. Short-term investments include investments in U.S. Treasury bills with values of $61,459,350 and $52,645,119 as of December 31, 2006 and 2005, respectively, with maturities of six months from the original issue date. Income earned on these investments was $3,034,531 and $1,359,187 during the years ended December 31, 2006 and 2005, respectively.

Depreciation and Amortization. Furniture and equipment, leasehold improvements, and technology are stated at cost, less accumulated depreciation and amortization computed under the straight-line method over their useful lives. Furniture and equipment and technology are depreciated over their estimated useful lives of three to five years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining term of the current office leases.

Taxes. The PCAOB is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. Therefore, the accompanying financial statements include no provision for federal income taxes. It is the PCAOB's position that because of its status and powers under the Act it is not subject to state and local taxation. The PCAOB has made filings with appropriate state and local taxing authorities to receive formal tax exemptions, where available. In those circumstances in which the PCAOB has not received a formal tax exemption and any possible tax liability would be significant, it will take appropriate steps to establish that it is not subject to state and local taxes in the relevant jurisdiction, pursuant to the Act.

NOTE 3—FURNITURE AND EQUIPMENT, LEASEHOLD IMPROVEMENTS AND TECHNOLOGY:

These assets consist of the following at December 31, 2006 and 2005:

	2006	2005
Technology:		
Hardware	$ 11,350,798	$ 9,844,770
Purchased and developed software	26,923,555	24,990,236
Leasehold improvements	9,183,767	7,431,619
Furniture and equipment	6,582,739	6,133,061
Technology development in process	475,969	1,599,314
	54,516,828	49,999,000
Accumulated depreciation and amortization	(34,697,102)	(22,473,326)
	$ 19,819,726	$ 27,525,674

Depreciation and amortization expense was $12,286,371 and $12,248,777 in 2006 and 2005, respectively.

NOTE 4—LEASE COMMITMENTS:

As of December 31, 2006, the PCAOB occupied office space in Washington, DC; New York, New York; Sterling, Virginia; San Mateo, California; Irvine, California; Atlanta, Georgia; Dallas, Texas; Chicago, Illinois and Denver, Colorado on leases that expire from 2006 to 2017. These operating leases include provisions for scheduled rent increases over the respective terms.

Rent is being expensed using the straight-line method over the respective lease terms. Rent under this method was $7,670,239 and $5,050,560 in 2006 and 2005, respectively. Deferred rent that has been expensed but will not be paid until future years totaled $8,838,868 and $7,042,939 as of December 31, 2006 and 2005, respectively, and is being amortized over the remaining lives of the office leases.

Minimum rental commitments under the office leases as of December 31, 2006 are as follows:

YEAR ENDING DECEMBER 31	
2007	$ 7,501,024
2008	7,621,367
2009	7,734,463
2010	8,014,934
2011	8,140,953
Thereafter	20,422,896
	$59,435,637

NOTE 5—RETIREMENT BENEFIT PLAN:

The PCAOB has a defined contribution retirement plan which covers active employees. The PCAOB matches contributions in an amount equal to 100% up to 6% of the eligible compensation. The PCAOB's contributions become fully vested immediately. The PCAOB's contributions to employees' accounts were $3,428,718 and $2,673,785 for 2006 and 2005, respectively.

NOTE 6—LITIGATION AND CONTINGENCIES:

In February 2006, the Free Enterprise Fund and Beckstead and Watts, LLP, filed a civil action in the U.S. District Court for the District of Columbia against the PCAOB and its current Board members in their official capacities (Case No 1:06CV00217). This action alleges that "the Board and all power and authority exercised by it violate the Constitution." The parties have filed dispositive motions, and the case is awaiting disposition by the District Court. The PCAOB intends to continue to defend this action vigorously.

Report of Independent Accountants

To the Board
Public Company Accounting Oversight Board
Washington, DC

We have audited the accompanying statement of financial position of the Public Company Accounting Oversight Board as of December 31, 2006 and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Public Company Accounting Oversight Board as of December 31, 2005 were audited by other auditors whose report, dated February 14, 2006, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2006 financial statements referred to above present fairly, in all material respects, the financial position of the Public Company Accounting Oversight Board as of December 31, 2006 and the changes in its net assets and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Blum, Shapiro + Company, P.C.

March 15, 2007

Public Company Accounting Oversight Board

BOARD MEMBERS

(From left to right) Bill Gradison; Mark W. Olson, Chairman; Kayla J. Gillan; Daniel L. Goelzer; Charles D. Niemeier

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