

September 12, 2006

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

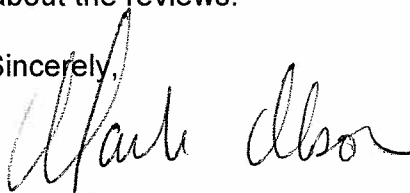
I am pleased to transmit to you a summary of the Public Company Accounting Oversight Board's most recent performance review, conducted by the Board's Office of Internal Oversight and Performance Assurance. The Board formed IOPA to provide the Board, the Securities and Exchange Commission, and others assurance that the PCAOB is achieving the objectives of Title I of the Sarbanes-Oxley Act in an effective manner. IOPA conducts its reviews in conformance with Government Auditing Standards issued by the Comptroller General of the United States.

This report discusses activities conducted by the Board's Office of Research and Analysis. It is the seventh and final report covering a series of reviews that IOPA performed to assess the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls. The Board is very supportive of IOPA's review process.

In response to the report's recommendations, the Director of Research and Analysis has worked to develop additional processes for identifying, defining, prioritizing, performing, and evaluating research projects. In the report, IOPA also made observations regarding additional integration of technology to further leverage data available to the Board in support of Research and Analysis activities. The Board discussed these observations with the Director of Research and Analysis and tasked him to develop an analysis of options, potential benefits, and impediments as they relate to additional technology integration.

The Board intends to publish the attached summaries of IOPA's reviews on the PCAOB's Web site on or about September 19, 2006. You and your staff should feel free to contact me or the Director of IOPA, Peter Schleck (202-207-9115), if you have any questions or would like any additional information about the reviews.

Sincerely,



Mark Olson
Chairman

cc: Paul S. Atkins, Commissioner
Roel C. Campos, Commissioner
Annette L. Nazareth, Commissioner
Kathleen L. Casey, Commissioner

PERFORMANCE REVIEW

INTERNAL CONTROL REVIEW OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S OFFICE OF RESEARCH AND ANALYSIS (IOPA-2006-003)

INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE September 12, 2006

Objective

On a regular basis, Internal Oversight and Performance Assurance conducts risk assessments of the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") major programs and functions. Based on assessments conducted to date, we designed a series of performance reviews to assess the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls over operations. As part of each review, Internal Oversight and Performance Assurance identifies and reports on the status of and any plans to enhance internal controls. Previous reports in this series have discussed controls in place over information technology, human resources, finance, and the Board's inspections activities. This report^{1/} focuses on the Office of Research and Analysis.

As with our previous reviews in this internal control series, we recognize that the PCAOB is a blend of organizational cultures that was established as a private sector entity yet charged with a public interest mission. Moreover, the Board has articulated its desire to foster a creative, non-bureaucratic work environment that encourages informed risk-taking and innovative strategies to achieve the PCAOB's statutory mandates. Our reviews are intended to help ensure that within this unique framework, PCAOB offices continue to establish robust internal standards, policies, procedures, and professional practices to guide operations on a day-to-day basis.

^{1/} This is a public summary of the report. The full report, prepared in accordance with Government Auditing Standards, has been issued to the Board. The full report includes a detailed discussion of the review objective, scope, and methodology.

For purposes of this review, we generally use the term "internal control" as defined by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission, reproduced below.

Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

While the COSO definition includes internal control relevant to financial reporting, it is important to note that COSO-defined controls also encompass business operations and the legal and regulatory framework in which an entity operates. Our review included all of these aspects of internal control, but it was not designed to allow us to express an opinion on internal controls over financial reporting in accordance with PCAOB Auditing Standard No. 2.^{2/} COSO's broad-based view of internal controls is consistent with Internal Oversight and Performance Assurance's charter to help ensure the efficiency, effectiveness, and integrity of PCAOB programs and operations.

Background

The Office of Research and Analysis was formed in September 2005, when the Board combined the former Office of Financial Analysis and Risk Assessment ("OFARA"), which had been created about one year earlier, and a risk analysis group that had been operating within the Division of Registration and Inspections since 2003. As stated in the Board's 2006 budget, the primary role of the Office of Research and Analysis is to identify and assess the risk of undetected material misstatements of the audited financial statements of public companies (whether intentional or unintentional) and to assess the effects of PCAOB activities (e.g., in crafting auditing standards) of public company audits. Other Board documents refer to the office's activities to "collect, analyze, and assimilate" information from multiple sources to provide the Board and other PCAOB staff with assessments of risk.

At the time of our review, the Director of the newly consolidated office was working to more fully integrate the staffs of the two former groups, but told us that there

^{2/} PCAOB engages an independent accounting firm to audit its annual financial statements.

would likely be a continuing distinction between the “tactical” work of the risk analysis group that came from the Division of Registration and Inspections and the more “strategic” research that characterized the former OFARA. For illustrative purposes in this report, we therefore refer to the “risk analysis group” and the “research group” even though no such formal distinction is made by the Director.

As of the end of 2005, Research and Analysis included 18 regular employees and four part-time interns. The office’s 2006 budget totaled \$4.7 million. An additional \$1.9 million is included in the Office of Information Technology budget for the support of Research and Analysis.

Since 2004, the Office of Research and Analysis and its predecessor organizations have developed a database, processes, and automated tools for providing risk profiles; produced a number of research reports; initiated projects to develop predictive fraud models; developed a range of contacts and data sources to support its operations; and, established a research library. We specifically noted that the office –

- Developed, working with the Board’s information technology staff, a database that includes, according to staff, information on about 1,600 registered accounting firms and 22,000 issuers.^{3/} Since 2004, the database has progressed through a number of development “phases” in which the staff has worked to add new sources of information and additional capabilities. The database relies on at least a dozen commercial data sources and also incorporates some information obtained through the PCAOB’s inspections.
- Provided internal risk profiles, based on information compiled in the database, to inspections teams for the Board’s 2004 and 2005 inspections. The risk profiles have been used extensively by the Division of Registration and Inspections to assist in the process of selecting firms and specific audit engagements for inspection. Moreover, users of this information were complimentary regarding its usefulness and the Research and Analysis staff’s diligence in providing the data in a timely and effective manner.

^{3/} The term “issuer” means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

- Produced a number of internal research reports on such issues as hedge accounting and credit derivatives, and initiated work on additional research topics, including pension accounting and securitizations. At least one of the completed research efforts contributed to ongoing work of the Board's Division of Enforcement and Investigations.
- Initiated efforts to develop and acquire modeling capabilities intended to help identify variables, scenarios, and situations that are predictive of material misstatements of financial statements. These activities include the development of a database of known reporting failures and the use of data-mining and econometric modeling techniques (in collaboration with an outside organization) to construct models predictive of audit failure. In addition, these techniques will be used to "back-test" the existing Research and Analysis database to determine whether its risk variables would have reliably helped to predict misstatements that occurred in the past.
- Established a research library available to all PCAOB employees. The librarian manages PCAOB's contracts with about two dozen vendors providing online research material. The library is also obtaining additional research sources that provide more numeric and statistical data, as opposed to text, and building a collection of printed materials.

Results of Review

Based on our analysis of documentation associated with these initiatives and discussions with Research and Analysis customers throughout the PCAOB, we concluded that the office achieved significant successes in its efforts to "collect, assimilate, and analyze" risk-related information. We observed, however, that aspects of the role and mission of Research and Analysis were not always well understood by those outside the office. In particular, awareness of and expectations for the office's research group varied, even among PCAOB's senior leadership. Moreover, while the documentation we reviewed evidenced a wide range of effort and expertise focused on researching aspects of audit risk, there was less clarity in the written material as to the overall research strategy. For example, the documentation contained limited information on how research topics would be selected or prioritized, or how outcomes would be communicated or distributed to intended users.

Internal Oversight and Performance Assurance is mindful that the Office of Research and Analysis is a relatively new consolidation of two predecessor organizations that will require additional time to more fully develop and document its processes. We are also aware that some aspects of the office's work are viewed as

tactical and others strategic and inherently long-term. In this regard, we observed that the objectives and processes for developing and providing risk profiles to the inspections program – generally viewed as a tactical activity – were routinely and well documented. Significantly less documentation was available describing the office’s research goals and approach for its research group.

The office’s ongoing efforts to further develop and describe research processes, methods, and goals are important because they will provide the Board with the best possible information on which to base policy and resource decisions. A more fully defined research program will also help the office, and the Board, maximize the benefits of the \$6.6 million budgeted for Research and Analysis and related technology for 2006 and, to the extent possible, evaluate the success of research activities.

Based on our observations, we recommended that the Director of Research and Analysis continue to develop and document additional processes and an internal communication strategy for the office’s research program. The Director concurred with the recommendations.