

Testimony Concerning
the
Public Company Accounting Oversight Board



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Chairman Oxley, Ranking Member Frank, and Members of the Committee:

I am pleased to appear before the House Financial Services Committee today on behalf of the Public Company Accounting Oversight Board (“PCAOB” or the “Board”). My appearance today marks the first time a representative of the PCAOB has appeared before a Congressional committee and it is fitting that it comes before a Committee whose leadership and members played such a significant role in the Board’s creation. Through this Committee’s hearings and subsequent passage of H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act (CARTA) on April 16, 2002, this Committee set the Congress on a path to the ultimate passage of the Sarbanes-Oxley Act of 2002. I want to commend the leadership shown by you, Mr. Chairman, and Ranking Member Frank, as well as all of the Members of this Committee, in this effort and your other efforts to restore investor confidence in the wake of the reporting failures that have plagued our capital markets in the last two years. We look forward to a long and cooperative relationship with this Committee and the Congress.

INTRODUCTION

A little over a year ago, the Congress passed and the President signed the Sarbanes-Oxley Act of 2002 (the “Act”).¹ The Act, of course, established the PCAOB and charged it with “oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the

¹ P.L. No. 107-204 (2002).

interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.”²

To carry out this vital charge, the Act gives the Board significant powers. Specifically, subject to the oversight authority of the Securities and Exchange Commission (the “Commission”), the Board’s powers include authority --

- To register public accounting firms that prepare audit reports for issuers;
- To conduct inspections of registered public accounting firms;
- To conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms;
- To enforce compliance by registered public accounting firms and their associated persons with the Act, the Board’s rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- To establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.³

For the remainder of my testimony, I want to give a brief overview of the organizational steps the Board has taken and then explain the steps the Board has taken to develop its four core programs of registration, inspection, enforcement and standards-setting.

² Sarbanes-Oxley Act, Section 101(a).

³ Sarbanes-Oxley Act, Section 101(c).

Overview of the Board's Organization

Since the initial Board members took office in January, the Board has taken a number of organizational steps to position it to carry out its core programs.

Staffing. Like any other start-up, much of the Board's effort has been devoted to creating an organizational structure and hiring staff members in a manner that will foster our long-term success. One of the Board's objectives in this regard is to foster a working environment marked by enthusiasm for the Board's mission and commitment to integrity. Starting from scratch in January 2003, the Board has grown to 80 regular full-time professional staff. While the staffing effort is still underway, most of the top positions have been filled. In addition, our inspections group, which ultimately will be the Board's largest division, has grown to some 21 inspectors. The Board hopes to have as many as 200 full-time staff on Board by the end of this year and anticipates that it will have 300 employees eventually.

Office Space. The Board has leased space and opened offices in Washington, D.C. and New York City, as well as an information technology center in Northern Virginia. The Board anticipates that the space it has secured will be adequate to meet the anticipated growth of the organization for several years.

Bylaws. To govern its operations and decision-making process, the Act contemplates that the Board, like other private corporations,⁴ will adopt bylaws.

⁴ Under the Act, the Board is a private body with the powers of a District of Columbia nonprofit corporation.

The Board adopted its initial bylaws at its first meeting on January 9, 2003, and amended them on April 25, 2003. The Board's bylaws were approved by the SEC on July 23, 2003.

Ethics Code. The Act also requires the Board to establish ethics rules and standards of conduct for Board members and staff. At its public meeting on June 30, 2003, the Board adopted an Ethics Code that will apply to Board members, staff, and designated contractors and consultants. The purpose of the Ethics Code is to ensure the highest standards of ethical conduct within the Board's operations, and to provide the public with confidence in the objectivity of the Board's decisions by seeking to avoid both actual and perceived conflicts of interests. As required under the Act, the Ethics Code has been submitted to the SEC for approval.

Public Accessibility. The Board recognizes the importance of keeping the investor community, the issuer community, the accounting profession, and the interested public informed of developments as the Board carries out its mission. The Board has established a general practice of conducting its rulemaking in a public forum and seeking public comment on proposed rules. We also maintain a web site, www.pcaobus.org, where we not only provide timely and detailed information about our rules and policies, but through which we also webcast our public meetings as well as the roundtable discussions that we hold to obtain public input on some of the substantive issues we are addressing.

Budget. Section 109(b) of the Act requires the Board to prepare and submit to the Commission for approval a budget for the Board's first fiscal year. At its public meeting on April 23, 2003, the Board approved a budget for the 2003 fiscal year of approximately \$68 million. The SEC approved the Board's budget on August 1, 2003.

Funding. The Act establishes a mechanism for the funding, by publicly traded companies, of the Board and of the accounting standard-setting body designated pursuant to Section 19(b) of the Securities Act of 1933.⁵ To implement this funding mechanism, on April 18, 2003, the Board issued final rules with respect to the allocation, assessment and collection of its accounting support fee.^{6/} The SEC approved the Board's funding rules on August 1, 2003. Under the Act and the Board's rules, larger public companies and investment companies are assessed based on their average market capitalization during the preceding year.⁷ As a result, about 62 percent of the issuers assessed will pay \$1,000 or less in accounting support fees to the PCAOB. The largest 1,000 issuers will pay about 87 percent of the total fees due. Pursuant to its rules, the

⁵ On April 25, 2003, the SEC designated the Financial Accounting Standards Board ("FASB") as the authoritative standard-setter under Section 19(b). The PCAOB is serving as the FASB's collection agent for purposes of assessing and collecting its accounting support fee. In addition, a smaller portion of the Board's budget is to be recovered through fees assessed on registered public accounting firms, based on the estimated costs associated with processing and reviewing the firms' registration applications and periodic reports.

^{6/} PCAOB Release No. 2003-003 (April 18, 2003).

⁷ Pursuant to the Board's rules, issuers with average, monthly market capitalization of less than \$25 million (and investment companies with net asset values, or market capitalization, of less than \$250 million) are not subject to the accounting support fee.

Board sent notices of assessment to some 8,500 issuers beginning on August 4, 2003.

Registration

Under the Act and the Board's rules, by this October 22nd, all U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must be registered with the PCAOB. To implement the registration of public accounting firms, the Board adopted registration rules on April 23, 2003 and the Commission approved the Board's registration rules on July 16, 2003.⁸

Registration is critical to the Board's regulatory oversight of public accounting firms. As a legal matter, registration is the predicate for the Board's other oversight programs – compliance with auditing and related professional practice standards, inspections, and investigations and discipline. In addition, registration provides the Board with critical information about the public accounting firms that apply for registration. As required by the Act, registration applications must include, among other things, a list of issuer audit clients and

⁸ In approving the Board's registration rules, the Commission stated:

Title I of the Act assigns the Board the formidable task of designing and implementing a registration and oversight system within a relatively short period of time. The investor protection goals of the Act justify the need for prompt action, but the importance of the Board's task and its potential impact on the public securities markets demand that it be undertaken in a thoughtful and reasoned manner. After careful review of the Board's proposed registration system, the Commission finds that it is consistent with the requirements of the Act and the securities laws and is necessary and appropriate in the public interest and for the protection of investors.

fees billed those clients, the number and a list of the firm's audit professionals, a statement of the firm's quality control policies, and regulatory and enforcement actions against the firm and its professionals. This information will both serve as the basis for the Board's registration decisions and help inform the Board's exercise of its authority and focus its limited resources appropriately.

Registration of a public accounting firm is not automatic upon application. In order to approve an application, the Board must determine that registration of the applicant is consistent with the Board's responsibilities under the Act to protect investors and to further the public interest in the preparation of informative, accurate, and independent audit reports for public companies.

To make that determination, the Board is committed to a careful and fair review of all applications. Under the Act, the Board must, within 45 days of receiving an application, either approve the application, provide notice of disapproval, or request additional information. While this requires a great deal of hard and thoughtful work in a short time, the Board is ably assisted by staff who are up to the challenge. The review of applications is well underway, and the Board anticipates no obstacles to successfully completing this initial round of registration.

To facilitate the registration process, and to support the Board's inspection and other functions, the Board developed its own web-based system for the registration of public accounting firms. Receiving application information from registering accounting firms in electronic format expedites the registration process and allows the Board to maintain a sophisticated database of information

relevant to its other processes. To facilitate registration further, the Board published in July a collection of answers to frequently asked questions about the registration process. We have also established a Help Line staffed by the analysts responsible for reviewing registration applications. Since its inception, these analysts have responded to over 850 telephone inquiries regarding the registration process. Last month, these analysts also contacted firms known to audit public companies which had not sought access to the Board's registration system to inform the firms of the applicable deadlines for registration. Through this outreach program, the analysts contacted approximately 500 firms.

The Board received its first registration application on, August 7, 2003, and as of September 10, 2003, the Board has received 419 applications. We are currently in the process of carefully reviewing all of the applications.⁹

Registration of Non-US auditors

Under the Act and the Board's rules, non-U.S. accounting firms that prepare or issue audit reports on U.S. public companies, or play a substantial role in the audit of a U.S. public company, must register with the PCAOB by April 19th of 2004.

⁹ In July, the Board proposed a rule on procedures by which a firm, once registered, may seek to withdraw from registration. Under the proposed rule, a registered firm may seek to withdraw its registration at any time if it is not engaged in activity for which registration is required. Withdrawal would not be automatic, but could be delayed until the completion of any pending or imminent disciplinary proceedings, or for the Board to complete other relevant processes, such as inspections and investigations. In the absence of a pending disciplinary proceeding, however, the proposed rule would not allow the Board to delay withdrawal for longer than two years. The Board is currently considering the comments it has received in response to that proposed rule.

Because registration is the predicate to all the Board's other oversight programs, an exemption from registration for non-U.S. accounting firms would be tantamount to a complete exemption from any oversight by the Board. The Board believes that investors in the U.S. markets are entitled to the same protections regardless of whether an issuer, or an issuer's auditor, is foreign or domestic, and that it should provide investors with confidence that non-U.S. issuers and auditors adhere to U.S. generally accepted accounting principles and U.S. auditing standards.

At the same time, the Board has made certain accommodations in light of the special issues raised by the registration of non-U.S. firms. Non-U.S. accounting firms need not provide certain information on their registration application if by providing such information the firm would be violating laws in the jurisdiction in which the firm is located. Moreover, the nature and scope of the Board's oversight over non-U.S. accounting firms that audit the financial statements of U.S. public companies is the subject of ongoing dialogue between the Board and its foreign counterparts. Through this dialogue, the Board is exploring ways of accomplishing the goals of the Act without subjecting non-U.S. firms to unnecessarily redundant or conflicting requirements.

Inspections

As you know, the Act requires the Board to conduct a continuing program of inspections of registered public accounting firms. The purpose of these inspections is to assess the degree of compliance of each registered public accounting firm, and associated persons of that firm, with the Act, the rules of the

Board, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

The Board's inspection program is, perhaps obviously, where we will have the most extensive contact with registered firms and their personnel. It is where we are going to find out about the quality of the audits that have been conducted, and it is one of the places where we will exert pressure to change auditor behavior, when necessary. It will provide us with a direct window into the registered firms to see how they are implementing the standards the Board sets, areas where they are doing particularly well, and areas where improvements are needed.

There are a number of areas on which our inspections will focus that have not been the traditional focus of the peer review process. These include—

- An evaluation of the “tone at the top” of registered firms. We want to know the nature of the messages that are coming from the highest levels of the firms and their frequency;
- We are going to look at partner compensation and promotion. We are going to look into what behaviors are rewarded – and thus reinforced – through compensation and promotions; and
- We will consider the firms' overall communication and training practices to all firm professionals.

On July 28, 2003, implementing the directive in Section 104 of the Act, the Board proposed rules relating to inspections of registered public accounting firms. The comment period has ended on the Board's rulemaking and the Board intends to finalize its inspection rules at an open meeting later this week.

Under the proposed rules —

- “Regular” inspections are to take place annually for those firms that issue audit reports for more than 100 U.S. public companies.
- Other firms are subject to regular inspection every 3 years.
- A “special” inspection may be authorized by the Board at any time.

For 2003, regular inspections, which will consist of limited procedures, are being conducted on the four largest accounting firms, who have agreed to cooperate with the Board prior to their registration. Those inspections are already in process. For 2004, regular inspections begin for all accounting firms. Inspections of those firms with less than 100 issuer audit clients will be phased in over the three-year inspection period.

Generally, under the Act, information obtained in inspections is confidential. Portions of a final inspection report that deal with criticisms of or potential defects in a firm's quality control system cannot be made public by the Board if the firm addresses the items to the Board's satisfaction within 12 months of the report. Final inspection reports will be provided to the Securities and Exchange Commission and appropriate state regulatory authorities, however, and the Board may refer information learned from inspections to relevant authorities and commence an investigation or disciplinary proceeding if the facts and circumstances warrant. Moreover, the Board has proposed rules pursuant to which the Board would publish reports about findings from the inspections process to discuss any matter the Board considers of public interest, including criticisms and potential defects in firms' quality control systems. Under that proposed rule, the Board would not identify specific firms in issuing such reports.

Investigations and Discipline

The Act authorizes the Board to conduct thorough investigations when there are indications that a registered firm or an associated person may have violated the Act, the Board's rules, certain provisions of the securities laws and the Commission's rules, or professional standards.¹⁰ The Act further authorizes the Board to use the results of those investigations as a basis for formal disciplinary proceedings.¹¹ If a violation is established in those proceedings, the Act authorizes the Board to impose a range of sanctions on the firm or associated person who committed the violation.¹²

On July 28, the Board publicly proposed an extensive set of rules relating to investigations and disciplinary hearings.¹³ We received substantial public comment on the proposal. We have been considering the comments and we expect to consider adopting final rules very shortly. We are also in the process of staffing a Division of Investigations and Enforcement, which will have responsibility for carrying out the Board's investigative work and prosecuting disciplinary proceedings.

Among other things, the Board's proposed rules implement the Act's provisions granting the Board broad authority to demand testimony, production of documents, and other cooperation from firms and associated persons during an

¹⁰ Sarbanes-Oxley Act, Section 105(b)(1).

¹¹ Sarbanes-Oxley Act, Section 105(c).

¹² Sarbanes-Oxley Act, Section 105(c)(4).

¹³ PCAOB Release No. 2003-012 (July 28, 2003).

investigation. As with inspection materials, the Act provides for the confidentiality of the Board's investigative processes and protects all such information from discovery by private parties.¹⁴ Firms and associated persons must provide the necessary information and cooperation, or risk the possibility of being sanctioned for noncooperation with an investigation. As provided in the Act and our proposed rules, noncooperation with an investigation can result in sanctions as severe as revoking a firm's registration or barring a person from association with a registered firm.¹⁵

The Board's investigative and disciplinary work will also necessarily involve a need to obtain documents and testimony from public companies and other persons who are not legally required to cooperate with our investigations. While the Act does not authorize the Board to compel cooperation from those persons, it does authorize the Board to ask those persons to supply information voluntarily. The Act also gives the Board the option of working through the Commission to serve legally enforceable Commission subpoenas for any such information that is relevant to a Board investigation but is not supplied voluntarily.¹⁶ Our proposed rules would implement these provisions as well.

The proposed rules also include detailed procedures to govern the conduct of Board disciplinary hearings in order to ensure a balanced process in which the respondent has fair notice of, and a full and fair opportunity to defend

¹⁴ Sarbanes-Oxley Act, Section 105(b)(5)(A).

¹⁵ Sarbanes-Oxley Act, Section 105(b)(3).

¹⁶ Sarbanes-Oxley Act, Section 105(b)(2)(C)-(D).

against, allegations of misconduct. Like the investigative process itself, disciplinary hearings will be nonpublic unless the Board and the respondent agree otherwise, as required by the Act.¹⁷

Finally, the proposed rules implement the Act's provisions for imposing sanctions if a violation is established through the hearing process. The sanctions the Board may impose range from the most severe sanctions – revocation of registration and bar on association – to lesser sanctions such as monetary penalties, limitations tailored to the particular violation, requirements to retain consultants for particular purposes, and requirements to obtain additional professional education.¹⁸

Professional Standards

The Act directs the Board to establish certain standards related to the work done by auditors of public companies. Those standards include standards for auditing and related attestation work, standards for quality controls, ethics standards, and independence standards. As part of the authority to establish standards related to auditor independence, the Act authorizes the Board to add to the categories of non-audit services that auditors are prohibited from providing to their audit clients. Early on, the Board made the decision to establish professional standards by creating a standard-setting division of the Board, made

¹⁷ Sarbanes-Oxley Act, Section 105(c)(2).

¹⁸ Sarbanes-Oxley Act, Section 105(c)(4). Under the Act, a firm or associated person sanctioned by the Board may seek review of that determination by the Commission. In the event of an appeal to the Commission, the Act provides that the sanction will be stayed unless and until the Commission affirms the sanction or otherwise affirmatively terminates the stay.

up of highly-skilled experts, rather than by delegating the standard-setting function to another body, such as the AICPA's Auditing Standards Board.

The Act required the Board to adopt professional standards as initial or transitional standards prior to the Commission's April 25, 2003, determination of the Board's capacity to carry out its responsibilities under the Act.¹⁹ Accordingly, at a public meeting on April 16, 2003, the Board announced the adoption of certain interim auditing, attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports,²⁰ and the Commission approved those standards as part of its April 25, 2003 determination.

The standards adopted on an interim basis include the standards with which the profession is, or should be, familiar. They include the following standards, as they existed on April 16, 2003:

- GAAS, as previously established by the AICPA, including Statements on Auditing Standards, auditing interpretations, auditing guidance included in AICPA Audit and Accounting Guides, and auditing Statements of Position;
- Attestation Standards and related interpretations and Statements of Position as previously adopted by the ASB;
- the AICPA's Statements on Quality Control Standards and certain AICPA SEC Practice Section membership requirements;
- the AICPA's Code of Professional Conduct on integrity and objectivity; and

¹⁹ Sarbanes-Oxley Act, Section 103(a)(3)(B).

²⁰ See PCAOB Release No. 2003-006 (April 18, 2003).

- the AICPA's Code of Professional Conduct regarding independence, and the standards and interpretations of the Independence Standards Board.²¹

The Board has not determined that any of these standards should be permanently adopted, however, and the Board has announced plans to review systematically all of the interim professional standards and to determine whether each of the interim standards should be modified, repealed, or made permanent.

The Board has also announced its plans for a general process related to setting the permanent auditing and other professional standards. The process will include the appointment of an advisory group, as envisioned by the Act,²² including members of the accounting profession, issuers, investors, regulators and others. The Board has adopted a rule concerning the composition of the advisory group²³ and expects to begin the process of forming the advisory group shortly after the Commission approves the rule.

We expect that the standing advisory group will be comprised of approximately 25 members with a variety of backgrounds. Our intent is that the standing advisory group act at a high level, providing advice and recommendations on policy matters, significant issues related to specific standards setting projects, and our agenda and priorities. The standing advisory group will not be a standards-setting committee, in the more traditional sense,

²¹ With regard to independence standards, if the SEC's rules are more restrictive, then registered public accounting firms are expected to comply with the more restrictive requirements.

²² Sarbanes-Oxley Act, Section 101(a)(4).

²³ See PCAOB Release No. 2003-009 (June 30, 2003).

drafting and debating all the provisions of proposed standards. Most of that work will be done by the Board's staff.

We also plan to use other means to obtain the expertise and advice of the profession and the public, including such things as ad hoc task forces based on our need for specific expertise. We also have the option of convening roundtable discussions, which we have already held on certain issues, public hearings, and other types of public forums to obtain input and advice as needs arise.

The Act itself sets forth the Board's initial standards-setting agenda. Section 404 of the Act, which mandates public reporting on internal control over financial reporting, becomes effective for fiscal years ending in June of 2004. On July 29, 2003, the Board held a public roundtable discussion to explore whether revised auditing and attestation standards on this subject are needed. The roundtable included representatives from issuers, auditors, investors, consumer groups, and regulators.

The Act also mandates that we establish requirements in the auditing standards for the retention of audit documentation and for a second-partner review, and we already are working on those subjects.

Conclusion

The Sarbanes-Oxley Act of 2002 has frequently, and rightly, been called the most significant legislation affecting securities markets, and the investors whose confidence fuels those markets, since the Securities Exchange Act of 1934. My fellow Board members and I are keenly aware of the profound responsibility that you have entrusted to the Board to make critical elements of

the legislation work. We are committed to exercising that responsibility wisely and effectively to accomplish the goals of the Act, and we look forward to working with you toward that end.