

# PCAOB

Public Company Accounting Oversight Board



*Restoring Confidence*

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.

*Public Company Accounting Oversight Board*



**Bill Gradison**  
Board Member

**William J. McDonough**  
Chairman

**Kayla J. Gillan**  
Board Member

**Charles D. Niemeier**  
Board Member

**Daniel L. Goelzer**  
Board Member



## *Letter from the Chairman*

I am pleased to present the annual report of the Public Company Accounting Oversight Board, recounting the accomplishments of the Board in the first year of operation of this remarkable organization.

What you will read in these pages is the story of the creation of an unparalleled regulatory body, charged by federal law to build a system of oversight that had never before existed, entailing the registration of public accounting firms, regular inspections of those firms, and provisions for the investigation and discipline of accounting firms that betray the public trust in their audits of publicly traded companies. This new body is required by federal law to set the standards that guide the audits of publicly traded companies and to establish and implement the funding structure that supports its activities.

The events that led Congress to take the radical step of ordering a new oversight regime for the accounting profession are well known: Beginning with the collapse of Enron in late 2001, investors and the American public were beset by a series of corporate failures that undermined confidence in U.S. securities markets and pointed to deep flaws in both corporate and regulatory governance.

The role of auditors in those corporate collapses caused the American people and their representatives in Congress to question—and reject—the existing system for policing of accounting firms, and the Public Company Accounting Oversight Board was conceived.

The PCAOB became reality on July 30, 2002, when President George W. Bush signed the Sarbanes-Oxley Act into law.

In addition to creating new oversight of auditors of public companies, the Act prescribed specific steps to address specific failures and codify the responsibilities of corporate executives, corporate directors, lawyers and accountants.

The merits, benefits, cost and wisdom of each of the prescriptions continue to fuel debate. But the context for the passage of the Sarbanes-Oxley Act, and the President's signing it into law, cannot be ignored: Corporate leaders and advisors failed. People lost their livelihoods and their life savings. The faith of America and the world in U.S. markets was shaken to the core.

To help restore faith in the audits of public companies, the Act first required the appointment of the Public Company Accounting Oversight Board, comprising five members “who have a demonstrated commitment to the interests of investors and the public.”

I hope that this report on the first year of the PCAOB will leave you with the conviction that not just the Board members, but the entire staff of this new organization have indeed demonstrated their commitment to the interests of investors and the public. None of what is described in these pages could have been accomplished without the dedication and self-sacrifice of a staff that numbered a mere 25 people a year ago.

You may have noticed the lack of a salutation on my letter. We are a private-sector, nonprofit organization, so addressing “shareholders,” as you might see in the annual report of a public company, would not be appropriate. The law, in fact, requires that we submit our annual report to the Securities and Exchange Commission, which will then transmit a copy to the committees that created the PCAOB in the U.S. Congress.

I thank our colleagues at the SEC and the members of Congress whose support undergirded our efforts. I believe they would join me in submitting the first annual report of the PCAOB to the people, in the United States and around the world, who look to U.S. securities markets as a model for fairness and reliability. The people will ultimately judge how well we at the PCAOB have done our jobs. I humbly submit that we have done our best to fulfill that awesome responsibility in this first year and that we will continue to do nothing less in the years to come.



**William J. McDonough**  
Chairman and Chief Executive Officer  
Public Company Accounting Oversight Board  
Washington, D.C.

June 2004

## Creation



With President Bush's signature on July 30, 2002, the Sarbanes-Oxley Act became law, and an unprecedented oversight organization was created.

The Act established an independent, nonprofit, non-governmental body to oversee the auditors of publicly traded companies "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

To accomplish this mission, the Act gave the new oversight body four primary responsibilities:

- Registration of accounting firms that audit public companies trading in U.S. securities markets;
- Inspection of registered accounting firms;
- Establishment of standards for auditing, quality control, ethics, and independence, as well as attestation, for registered accounting firms; and
- Investigation and discipline of registered accounting firms and their associated persons for violations of law or professional standards.

The Act required the Securities and Exchange Commission to select a Board made up of "individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public..."

The Commission named the founding members of the Board on October 25, 2002.

From then on, it was up to the Board to take all necessary action, "including hiring of staff, proposal of rules and adoption of initial and transitional auditing and other professional standards," that would enable the SEC to determine that the PCAOB had the capacity to meet the requirements of the Act.

The Act set the deadline for the SEC's determination at April 25, 2003. The Act also gives the SEC oversight authority over the Board. In addition to appointing or removing members, the SEC, among other things, must approve the Board's budget and rules, including auditing standards, and may review appeals of adverse Board inspection reports and disciplinary actions against registered accounting firms.

With the assistance of a handful of staff members, founding Board members Kayla J. Gillan, Daniel L. Goelzer, Bill Gradison and Charles D. Niemeier opened the doors

of the PCAOB's first offices on January 6, 2003. The Board held its first public meeting on January 9, 2003, where the members adopted bylaws for the organization and announced an aggressive campaign to hire the staff that would enable the Board to fulfill its mission.

At a series of public meetings in March and April, the Board proposed its rules for the registration of accounting firms, including non-U.S. firms, adopted interim auditing standards and related standards for professional practice, proposed its ethics code, and submitted its Fiscal Year 2003 budget to the Commission.

## There is established the Public Company Accounting Oversight Board...

Title I, Sec. 101(a), Sarbanes-Oxley Act of 2002

In March, the Board also proposed the establishment of the accounting support fees that would finance the PCAOB's operations in future years. These fees, as provided in the Act, are to be paid by publicly traded companies and mutual funds—guaranteeing that the Board's funding would be independent of the accounting profession as well as the federal government.

The Board organized its internal divisions and offices to match the responsibilities it was assigned by the Act. The Division of Registration and Inspections was charged with building the registry of accounting firms and preparing for inspections of the firms. The Office of the Chief Auditor and Professional Standards was created to advise the Board on standards-setting. The Division of Enforcement and Investigations was formed to perform investigations of possible violations of law or professional standards and to recommend to the Board any disciplinary action.

To support the primary functions required by the Act, the Board created other key offices. The Office of General Counsel was established to provide legal advice and assist the Board's rulemaking functions. The Office of Administration was given responsibility for three areas that



would be vital to the Board's success: information technology, which developed the technology infrastructure to support all of the Board's programs, including the Web-based registration of accounting firms; human resources, tasked with hiring the dozens of inspectors and other staff needed to carry out the PCAOB's work; and the office of finance, which would administer the accounting support fees, among other things.

On April 25, 2003, six months after the founding Board had been named, the SEC issued the determination required by the Sarbanes-Oxley Act. The members and staff of the PCAOB had demonstrated that they could fulfill the responsibilities of the Sarbanes-Oxley Act.

On May 21, 2003, the SEC unanimously approved the appointment of William J. McDonough as Chairman of the PCAOB.

The Board and the staff aggressively addressed the next deadline imposed by the Sarbanes-Oxley Act: the registration of public accounting firms. Under the Act and the Board's rules, after October 22, 2003, only registered U.S. accounting firms could audit or substantially participate in the audit of a publicly traded company. Through the summer of 2003, the Board's information technology team completed the construction of the Web-based system for registration. The SEC approved the Board's rules and form for registration on July 16, 2003. Registration applications were available online beginning July 17, and by October 22, the Board had approved the registration of 598 firms. Applications continued to arrive after the October 22 deadline, and by December 31, the Board had approved the registration of 735 firms.

The Act requires a continuing program of inspections of registered public accounting firms that audit public companies. In mid-2003, even though the largest firms were not yet registered, the Board launched limited inspections of those four firms in the belief that investors and the public would best be served by immediate inspections to help restore investor confidence in public company auditing. After seeking and considering public comment, on October 7, 2003, the Board adopted the rules that would guide the inspections of all registered accounting firms—annual inspections for firms with more than 100 public

company clients and inspections no less frequently than every three years for other firms—as well as special inspections. To accomplish the inspections, the Board opened an office in New York in September 2003 and began hiring staff for additional offices near Atlanta, Dallas, and San Francisco. The Board paid close attention to hiring a cadre of experienced auditors to conduct the inspections, and by year's end, the PCAOB inspection staff had grown to 60.

While registration and limited inspections were under way, the Board, through its Office of the Chief Auditor and Professional Standards, began addressing the momentous task of developing standards for the audits of publicly traded companies. The Board held two roundtable discussions with investors, issuers, and auditors to discuss standards for audits of internal control and audit documentation, and it adopted rules for the establishment of a standing advisory group to provide guidance on standards-setting. On October 7, 2003, the Board proposed the most complex standard required under the Sarbanes-Oxley Act: the standard for auditors' attestation to management's assessment of internal control over financial reporting.

The proposal of the internal control standard was one of almost a dozen rulemaking actions taken by the Board in the last half of 2003. The Board also proposed or adopted rules for inspections of accounting firms, for investigations and adjudication, and for oversight of non-U.S. accounting firms that audit U.S. public companies.

During the year, the Board also established offices of public affairs and government relations to assist the Board in communications with the public, Congress, and the news media. The Board also hired an international affairs staff to advise the Board on international issues and facilitate dialogue with foreign regulators regarding oversight of registered non-U.S. accounting firms. The Board also began hiring the staff for investigations and enforcement.

Four Board members and a handful of staff members had opened the doors to the organization's first office on January 6. By December 31, the organization was 118 strong. The Public Company Accounting Oversight Board was well established and well on its way to fulfilling its statutory duties to investors and the public.

# Registration



Before the Sarbanes-Oxley Act of 2002, the accounting profession largely operated outside the purview of national oversight. Individual accountants were subject to the education and certification requirements of the states in which they practiced, and accounting firms voluntarily participated in self-regulation through a national professional organization. Federal securities laws set certain requirements for and limits on the work of auditors of publicly traded companies, but none of the federal or state regulations approached the regime of oversight set out by the Sarbanes-Oxley Act.

The requirements of the Act compelled the Public Company Accounting Oversight Board to construct an unprecedented registry of domestic and non-U.S. accounting firms that audit, or play a substantial role in the audits of, public companies and mutual funds. With registration, accounting firms become subject to the Board's inspections, auditing standards and enforcement authority.

The Board proposed its rules for the registration of public accounting firms on March 4, 2003—just two months after the Board began operations. The proposed rules sought the information required of such firms under the Sarbanes-Oxley Act, including:

- The names of all issuers for which the firm prepared or issued audit reports during the immediately preceding calendar year, and for which the firm expects to prepare or issue audit reports during the current calendar year.
- The annual fees received by the firm from each issuer for audit services, other accounting services and non-audit services, respectively.
- A statement of the quality control policies of the firm for its accounting and auditing practices.
- A list of all accountants associated with the firm who participate in or contribute to the preparation of audit reports.
- Information relating to relevant criminal, civil, or administrative actions or disciplinary proceedings pending against the firm or any associated person of the firm.

The Board, in its proposed rules, sought a limited amount of supplemental information to assist it in making registration decisions. After considering the comments it received, the Board adopted a final rule for registration of accounting firms on April 23, 2003, and the rule was approved by the SEC on July 16, 2003.

The rules, in keeping with the Act, require the registration of both U.S. and non-U.S. accounting firms that audit or play a substantial role in the audits of companies trading in U.S. markets. The Board was sensitive to the special concerns of foreign accounting firms and solicited a public roundtable discussion with non-U.S. government representatives and other interested persons on March 31, 2003. As a result, the Board provided certain accommodations in the registration process for foreign firms, including giving those firms additional time to register, ultimately setting the deadline for July 19, 2004.

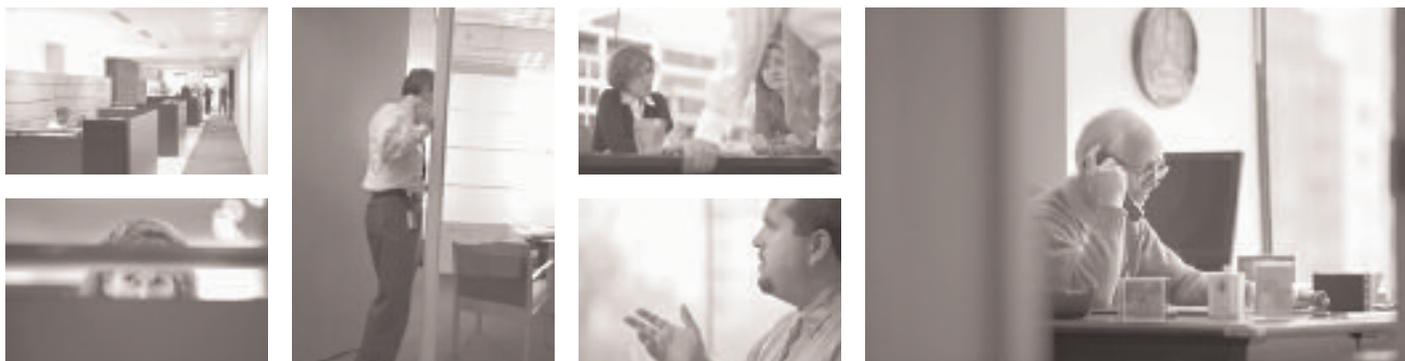
**[I]t shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.**

—Title I, Sec. 102(a), Sarbanes-Oxley Act of 2002

## **Building the Registration System**

Because of the importance of registration to the Board's oversight responsibilities, the Board chose to build the registration system and not outsource the registration function.

The Board recruited a team of experienced information-technology specialists who, working with the Board's registration and inspections staff, designed the Web-based system that would capture the information required from registration applicants while both protecting the confidentiality of the information and giving the Board's staff the ability to efficiently examine and analyze the information.



Work on the system began early in 2003, and it was ready for launch the day after the SEC approved the Board's registration rules.

The Board began accepting applications and fees in early August 2003 and made the names of applicants available to the public through its Web site beginning

By the statutory deadline of October 22, the Board had answered the question affirmatively for 598 public accounting firms, including the four largest U.S. firms. The Board made the names of the registered firms available to the public through its Web site to enable public companies and mutual funds to confirm that their auditors were registered as required by law. The applications will be made public after requests for confidential treatment of certain information in the applications are evaluated.

Registration applications continued to be filed after October 22, and the Board and staff continued the process of reviewing and considering the applications. By December 31, 735 firms were registered with the PCAOB.

The Board's rules also provide for hearings on registration applications. If the Board is unable to determine that a public accounting firm's application has met the standard for approval, the Board may provide the firm with a notice of a hearing, which the firm may elect to treat as a written notice of disapproval that can be appealed directly to the Securities and Exchange Commission. Alternatively, a firm may request a hearing by the Board.

## The Act compelled the Public Company Accounting Oversight Board to construct an unprecedented registry of domestic and non-U.S. accounting firms that audit, or play a substantial role in the audits of, public companies and mutual funds.

August 27. The Act and the Board's rules give the Board a 45-day period to review each application, after which the Board is required to approve the application, provide the applicant with a notice of a hearing to determine whether the application should be approved or disapproved, or request more information from the applicant, triggering another 45-day review period.

### Evaluating Applications

In early September, the Board began considering applications. The Board reviewed, among other things, legal and disciplinary proceedings against the applicant firms, the firms' descriptions of their quality-control policies, the number and nature of audit clients, staffing levels, and any reported disagreements with clients. The decision on each applicant was based on a single consideration: is registration of this accounting firm consistent with the Board's responsibilities to protect investors and to further the public interest in the preparation of informative, fair and independent audit reports?

### Registered Firms by Number of Clients

Number of issuer clients	Fee for registration	Number of firms registered in 2003
0	\$ 250	141
1-49	\$ 500	579
50-100	\$ 3,000	7
101-1,000	\$ 29,000	4
1,001+	\$390,000	4

The Board's rules also set out procedures for firms to withdraw from registration. Withdrawal is not automatic. The Board may order that withdrawal be delayed, for up to 18 months, while the Board carries out a relevant inspection, investigation, or disciplinary proceeding.

# Inspections



The inspection of registered accounting firms carries the potential for real-time improvement in the audits of public companies and will require the largest commitment of the Board's human and monetary resources.

This powerful tool gives the Board access to critical information relating to audit quality, ranging from competence and methodology to judgment and integrity. Inspections will provide insight into the registered firms' audit practices to see how firms implement applicable auditing and related professional practice standards, how they comply with applicable laws and rules, where they are doing well, and where improvements are needed. The inspection process will allow the Board to assess all of these things and, when necessary, to apply pressure to improve a firm's audit practices.

The Sarbanes-Oxley Act requires the Board to conduct annual inspections of registered accounting firms that audit more than 100 public companies. Eight such firms were registered with the PCAOB as of December 31. Other firms that audit, or play a substantial role in the audit of, any public companies are required to be inspected at least once every three years.

The Board also has the authority to conduct special inspections as is necessary or appropriate to address issues that come to the Board's attention.

At the end of each inspection, the Board will issue a report of its findings, including criticisms of, and descriptions of potential defects in, the firm's quality control systems. The Act requires the Board to keep nonpublic any criticisms and potential defects unless the firm fails to correct them within 12 months.

The Board proposed its rules for inspections at a public meeting on July 28, 2003. After considering public comment, the Board adopted the inspection rules on October 7, 2003. The rules create a procedural framework for the conduct of the Board's inspection program.

The Board also determined that conducting limited inspections of the four largest firms would provide an important foundation for the full-scale inspections to come. Accordingly, the Board developed inspection procedures and conducted initial limited inspections of the four largest public accounting firms in the United States with the firms' consent.

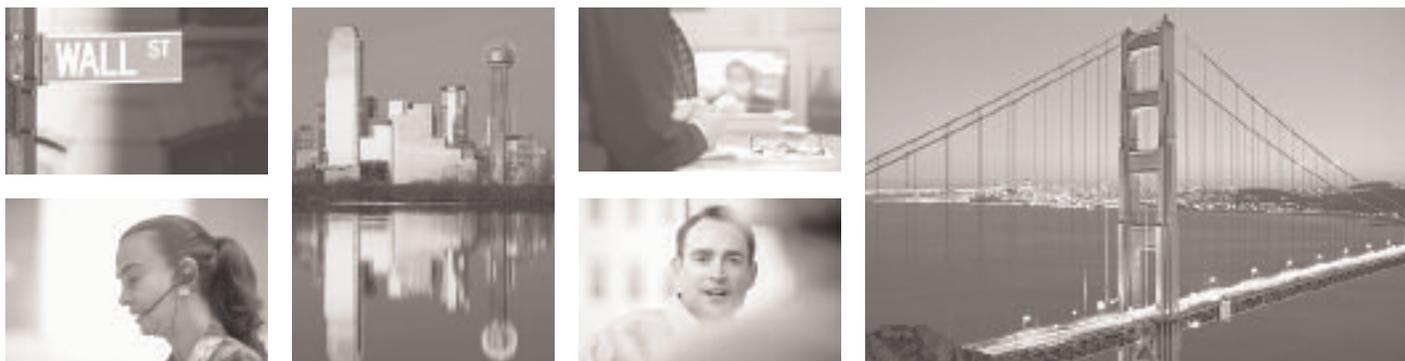
These initial limited inspections focused on areas that have not been the traditional focus of the auditing profession's own peer review process, including "tone at the

**The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.**

—Title I, Sec. 104(a), Sarbanes-Oxley Act of 2002

top" and partner evaluation, compensation, and promotion. The Board's inspectors also looked at how these firms performed selected audit engagements. The limited inspection procedures carved the path for the Board's comprehensive inspections program, which the Board will fully launch in 2004.

The fieldwork for the 2004 inspections will be conducted from approximately May to November 2004. In connection with these inspections, the Board will focus on, among other things, efforts to detect fraud, the adequacy of documentation, the evaluation of firm risk assessments, and compliance with professional standards. The Board also expects to continue its focus on



“tone at the top,” compensation practices, and other business practices that were the subject of limited procedures in 2003.

To help carry out its inspection program, the Board opened an office in New York in September 2003 and began hiring staff for additional offices near Atlanta, Dallas, and San Francisco. The Board recruited a cadre of experienced public company auditors to conduct the inspections, and by year’s end, the PCAOB inspection staff had grown to 60. The Board expects to more than double its inspection staff by the end of 2004 in order to carry out its statutory mandate.

The Board’s inspection teams are composed of accountants, who have an average of 12 years of auditing experience. Each team is led by an Associate Director or a Deputy Director of the Board’s Division of Registration and Inspections, who are generally former partner-level employees of the major accounting firms and have an average of 22 years of auditing experience. The Board’s ability to implement meaningful and robust inspections is a direct reflection of its inspections teams’ high caliber, experience, and commitment.

The Board’s statutory responsibilities extend to non-U.S. accounting firms that perform audit services for U.S. public companies or for non-U.S. issuers who are registered, and file reports, with the SEC. Accordingly, the Board’s inspection program will encompass firms outside of the United States. As a result of a dialogue with its foreign counterparts and as part of a cooperative approach to the oversight of non-U.S. registered

firms, the Board proposed a rule that would permit the Board to rely on the work of oversight systems in other jurisdictions, to an appropriate degree, on a case-by-case basis. In 2004, the Board will continue its dialogue with regulators in other countries in order to develop work programs for the inspections of non-U.S. firms.

#### Number of Issuers per Registered Firm

Registered firms (2003)	Issuer clients
8	100 or more
5	51–100
22	26–50
60	11–25
77	6–10
563	5 or fewer

Initial limited inspections focused on areas that have not been the traditional focus of the auditing profession’s own peer review process, including “tone at the top” and partner evaluation, compensation, and promotion.

# Auditing Standards



The Sarbanes-Oxley Act gives the Public Company Accounting Oversight Board considerable leeway in the design and adoption of standards for audits and professional conduct by auditors. Among other things, it authorizes, but does not require, the Board to designate a professional group of accountants to propose standards to the Board.

Early in 2003, the Board determined that it could best fulfill its mandate for the protection of investors by developing standards itself, with the assistance of a staff of highly qualified accountants recruited from academia, professional practice, and government.

As a result of the Board's decision, for the first time, the individuals developing auditing standards will have access to robust empirical and anecdotal evidence from the Board's inspections and enforcement activities—evidence that will cut through a cross-section of audits and firms—to assist in setting priorities and developing new standards.

The Act and the Board's rules require registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, as well as its independence rules. Any registered accounting firm that fails to adhere to applicable standards may be subject to Board discipline.

New auditing standards will be established—and existing standards will be changed—only by Board rulemaking. While the Board will consider proposed new or amended auditing standards recommended to it by others, no such proposed rule will become a standard of the Board unless adopted by the Board through rulemaking.

The Board will also rely on advice from a standing advisory group to assist it in performing its standards-setting responsibilities. The Board also intends to solicit public comment, and, where appropriate, to convene hearings or roundtable meetings in order to obtain the views of issuers, accountants, investors, and other interested persons with respect to proposed auditing standards. In this regard, the Board welcomes input and advice from established professional bodies and includes practicing accountants among the members of its advisory groups.

## Interim Auditing Standards

On April 16, 2003, the Board adopted certain existing standards as its interim auditing standards. Most of these standards were promulgated by the American Institute of Certified Public Accountants and pre-date the Board's formation. These interim standards are incorporated into the Board's rules. Registered public accounting firms are subject to the same obligation to comply with the interim standards while they are in effect as with permanent standards adopted by the Board.

**The Board shall, by rule, establish...such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.**

—Title I, Sec. 103(a), Sarbanes-Oxley Act of 2002

Despite the need to adopt these existing standards in order to assure continuity and certainty in the standards that govern audits of public companies, the Board has not determined whether it would be appropriate to include any of the interim auditing standards as permanent Board standards.

The Board will be mindful of the need to adopt new auditing standards, especially in response to emerging issues and problems that arise in connection with audits of issuers.



### **Audits of Internal Control over Financial Reporting**

In 2003, the Board also set out to fulfill other provisions of the Act that require the Board to adopt standards in specific areas. The most complex of the required auditing standards related to an auditor's responsibility in regard to a public company's internal control over financial reporting.

For the first time, the individuals developing auditing standards will have access to robust empirical and anecdotal evidence from the Board's inspections and enforcement activities—evidence that will cut through a cross-section of audits and firms—to assist in setting priorities and developing new standards.

The Sarbanes-Oxley Act, in Section 404, requires company management to assess and report on the company's internal control over financial reporting. It also requires a company's independent, outside auditors to issue an "attestation" to management's assessment—in other words, to provide shareholders and the public at large with an independent reason to rely on management's description of the company's internal control over financial reporting.

The Board convened a public roundtable discussion on July 29, 2003, to discuss issues and hear views related to reporting on internal control. The participants included representatives from public companies, accounting firms, investor groups, and regulatory organizations.

After considering comments made at the roundtable, advice from the Board's staff, and other input, the

Board developed and issued, on October 7, 2003, a proposed auditing standard titled "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."

The Board received 194 comment letters from a variety of interested parties, including auditors, investors, internal auditors, issuers, regulators, and others on a broad array of topics.

The final standard for audits of internal control, adopted by the Board on March 9, 2004, incorporated certain suggested changes and reflected certain basic principles on which the Board members agreed:

- Audit quality would be best improved by integrating the auditor's examination of internal control into the audit of a company's financial statements.
- The costs of an audit of internal control must be reasonable, particularly for small and medium-sized companies.
- Outside auditors may rely on the work of internal auditors and others, based on their competency and objectivity.
- An assessment of the effectiveness of a company's audit committee is a vital part of an audit of internal control and consistent with existing standards.

### **Audit Documentation**

The Act directs the Board to adopt a standard requiring registered public accounting firms to prepare, and maintain for a period of not less than seven years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report.

The Board sought expert advice on the standard from auditors, regulators, investors, and issuers during a roundtable discussion on September 29, 2003, and proposed its standard for audit documentation on November 12, 2003.

The standard will be one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The integrity of the audit depends in large part on the existence of a

# Auditing Standards

(CONTINUED)



complete and understandable record of the work that the auditor performed, of the conclusions that the auditor reached, and of the evidence that supports those conclusions. Meaningful review by a second partner, or by the Board in the context of its inspections, would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential in order to enhance the quality of the audit and for the Board to fulfill its mandate to inspect registered public accounting firms “to assess the degree of compliance” of those firms with applicable standards and laws.

The standard would establish general requirements for documentation that the auditor should prepare and retain in connection with issuing an audit report on the financial statements of a public company. The

standards of the Public Company Accounting Oversight Board (United States).” The standard supersedes previous standards that required references to “generally accepted auditing standards,” “U.S. generally accepted auditing standards,” “auditing standards generally accepted in the United States of America,” and “standards established by the AICPA.” The standard was approved by the Securities and Exchange Commission on May 14, 2004, and became effective on May 24, 2004.

## Advisory Groups and Task Forces

The Act provides that the Board shall “convene, or authorize its staff to convene, such expert advisory groups as may be appropriate... to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section.”

On June 30, 2003, the Board adopted a rule describing its intention to convene a standing advisory group to participate in the standards-setting process. The advisory group will assist the Board in reviewing existing auditing standards, in formulating new or amended standards, and in evaluating proposed standards suggested by other persons. The Board may, based on the circumstances of particular projects, form *ad hoc* task forces composed of smaller groups of members of the advisory group, of the Board’s staff, and other persons.

The Board began soliciting nominees for membership in the standing advisory group in November 2003 and received more than 170 nominations. The Board named the members of the standing advisory group in April 2004—30 individuals with a variety of perspectives, including practicing auditors, preparers of financial statements, the investor community, academia, and others.

The standard for audit documentation will be one of the fundamental building blocks on which both the integrity of audits and the Board’s oversight will rest.

standard would also set a new requirement that audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, who performed it, when it was completed, and the conclusions reached.

## Auditing Standard No. 1— References to PCAOB Standards

On December 17, 2003, the Board adopted Auditing Standard No. 1, requiring registered public accounting firms to include in their reports on the financial statements of public companies a statement that the engagement was conducted in accordance with “the



Each member of the advisory group has expertise in at least one of the following areas: public company accounting; public company auditing; public company finance; public company governance; investing in public companies; or other disciplines that the Board deems to be relevant.

The members of the advisory group will serve in their individual capacities and may not delegate their duties as advisory group members, including attendance at meetings. Advisory group members are also subject to certain

The standing advisory group comprises 30 individuals with a variety of perspectives, including practicing auditors, preparers of financial statements, the investor community, academia, and others.

provisions of the Board’s Ethics Code, including provisions designed to protect nonpublic information and avoid conflicts of interest.

The European Commission recently proposed that financial statement audits in the European Union should be conducted in accordance with International Standards on Auditing, as developed by the International Auditing and Assurance Standards Board (the IAASB) and to the extent endorsed by the European Commission. In 2003, the Board accepted an invitation to observe, with speaking rights, the meetings of the IAASB. Similarly, the Board invited the IAASB to participate as observers in the standing advisory group. Although not an explicit objective of the Board, the Board supports the development of high-quality international professional standards.

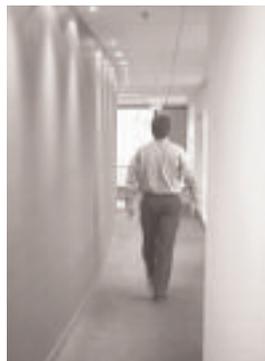
### Future Standards-Setting

While the Board has made significant strides its first year in crafting a process for setting standards in the public interest and in proposing and adopting certain of those standards, it still faces a challenging future agenda. Among the issues that the Board, its staff, and the standing advisory group expect to discuss in the coming year are:

- Reviews of existing, interim standards;
- Revision to the hierarchy for generally accepted auditing standards—to incorporate PCAOB auditing and related professional practice standards;
- Concurring or second partner review—to ensure all public company audits include a review by a second partner, and
- Communications and relations with audit committees—to incorporate requirements mandated under the Sarbanes-Oxley Act into the audit and related professional practice standards.

In addition, the Board is considering projects related to the quality control and independence standards, which Congress specifically addressed in the Sarbanes-Oxley Act.

## Enforcement & Investigations



The ability to impose disciplinary measures on errant accounting firms and auditors is one of the strongest tools given to the Board for the protection of investors. The Board is empowered to impose penalties as harsh as revocation of a firm's registration—effectively barring the firm from auditing publicly traded companies—and monetary penalties of as much as \$15 million per offense.

In September 2003, the Board laid the groundwork for its enforcement program by adopting detailed rules to govern its investigative and disciplinary processes and to provide fair procedures for the conduct of investigations, the conduct of hearings, and the imposition and termination of sanctions. The rules were approved by the Securities and Exchange Commission on May 14, 2004.

The overall objective of the Board's enforcement program is to promote improvements in the quality of public company auditing by taking remedial and disciplinary measures with respect to—or, where appropriate, barring—registered accounting firms and associated persons that have failed to comply with the Sarbanes-Oxley Act, the rules of the Board, and the rules of the Securities and Exchange Commission relating to the preparation and issuance of audit reports or professional standards.

When a violation of those rules or standards is confirmed, the Board will impose sanctions intended to prevent a repetition of the violation and to enhance the quality and reliability of future audits.

The Board will implement its enforcement program with an emphasis on three important criteria:

- *Speed.* The Board believes it is important that it promptly and efficiently investigate significant instances of apparent audit failure. Prompt investigation will help shore up investor confidence.
- *Fairness.* The Board is committed to the principle that persons charged with violations should have a full and fair opportunity to present relevant evidence and arguments in their defense before any final determination is made.

- *Thoroughness.* Disciplinary proceedings should be based on a comprehensive assessment of the relevant facts.

**The Board shall establish...fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.**

—Title I, Sec. 105(a), Sarbanes-Oxley Act of 2002

The Act and the Board's rules require registered public accounting firms and their associated persons to cooperate with Board investigations. The Act and the Board's rules also permit the Board to seek information from other persons, including clients of registered firms and, should those persons not comply, to seek issuance of a Securities and Exchange Commission subpoena for the information.

As part of the cooperative approach to the oversight of non-U.S. accounting firms, the Board has proposed a rule that would allow the Board, under certain circumstances, to rely on the investigation or a sanction of a non-U.S. oversight authority.

## Financial Review

Public Company Accounting Oversight Board  
*Year Ended December 31, 2003*

The year 2003 was the initial operating year for the Public Company Accounting Oversight Board. The financial statements reflect significant investments in technology and hiring necessary for the Board to implement its mission to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

Each year, the PCAOB develops an operating budget that must be approved by the Securities and Exchange Commission, as required by the Sarbanes-Oxley Act of 2002. On April 23, 2003, the Board adopted a 2003 budget of \$68 million, which was approved by the SEC on August 1, 2003.

The Board's start-up expenses were covered by advances from the Department of the Treasury, as authorized by the Act. The advances, drawn over the first eight months of the year, totaled \$20,342,000 and were repaid in full on September 22, 2003, from the proceeds of the 2003 accounting support fees.

### OPERATING REVENUE

The Act provides that the Board be funded by accounting support fees assessed on issuers as defined in the Act. The Board adopted rules for the allocation, assessment, and collection of accounting support fees on April 16, 2003, and the rules were approved by the SEC on August 1, 2003.

The accounting support fees or "fees from issuers," as reflected in the financial statements, are equal to the Board's budget for the fiscal year in which they are set, less the amount of fees received from public accounting firms to cover the cost of processing and reviewing registration applications.

Under the Act and the Board's rules, the annual accounting support fees are 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 fees.

The Board issued invoices to approximately 8,500 issuers beginning in early August 2003. The Board collected approximately \$51 million in accounting support fees. Approximately 62 percent of the issuers received invoices for \$1,000 or less, and the largest 1,000 issuers received invoices for about 87 percent of the total fees.

Combined, publicly traded companies contributed about 95 percent of the total fees paid, while open-end mutual funds provided about 4.7 percent, and other investment companies paid the remainder.

Another source of revenue is the registration of public accounting firms that audit public companies. This is reflected as "fees from registering accounting firms" in the financial statements. These amounts are not used to fund the Board's operations but to recover the costs of processing and reviewing the registration applications. During 2003, the PCAOB registered 735 public accounting firms. Each applicant paid a registration fee to the Board based on the number of issuers the firm audited in the preceding calendar year. The total amount collected from registration applicants in 2003 was approximately \$2 million.

### Assessment of Accounting Support Fees for 2003

Fee	Number of issuers
\$100–500	4,244
\$501–1,000	1,094
\$1,001–5,000	1,911
\$5,001–10,000	472
\$10,001–50,000	536
\$50,001–100,000	75
\$100,001–500,000	80
\$500,001–1,000,000	8
\$1,000,001+	4
<b>Total</b>	<b>8,424</b>

Financial Review (continued)  
Public Company Accounting Oversight Board  
*Year Ended December 31, 2003*

**STATEMENT OF FINANCIAL POSITION**

The PCAOB financial statements have been prepared in accordance with U.S. generally accepted accounting principles and are presented pursuant to Statement of Financial Accounting Standards 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 primarily consist of its investments in technology and amounts to fund operations in the subsequent year prior to collection of that year's accounting support fees.

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 approximately \$300,000 of cash collected on behalf of the Financial Accounting Standards Board (FASB). A corresponding amount of approximately \$300,000 is included in accounts payable and other liabilities for amounts due to the FASB. The Financial Accounting Foundation (FAF) designated the PCAOB as the collection agent for invoicing and collection of the 2003 FASB accounting support fees, as authorized by the Sarbanes-Oxley Act. In August 2003, the PCAOB issued invoices for accounting support fees of approximately \$25 million on FASB's behalf. The PCAOB earned and was paid approximately \$210,000 for acting as FASB's collection agent in 2003.

Accounts receivable of approximately \$2.2 million are almost entirely related to outstanding accounting support fees. As of year end, \$567,000 of these fees

remained uncollected. Roughly \$1.4 million of the accounts receivable balance represents amounts due from approximately 430 issuers of American Depositary Receipts that were assessed incorrect accounting support fees due to errors in the market capitalization figures used to calculate their fees. The PCAOB withdrew the initial invoices on August 27, 2003, and issued new invoices as part of the billing cycle for the 2004 accounting support fee. Because the fees originally assessed to the 430 issuers were higher than they should have been, the errors effectively reduced the PCAOB's 2003 anticipated revenue by approximately \$15.5 million and had the effect of reducing the share of the accounting support fee billed to and collected from all other issuers subject to the fee by that amount.

During 2003, the PCAOB invested approximately \$19.1 million in furniture and equipment, leasehold improvements, and information technology to build the infrastructure of the organization. The PCAOB established its headquarters in Washington, D.C., a regional office in New York City, and a Northern Virginia office for its information technology group.

The investment in information technology included the design, development, and implementation of two proprietary software systems in 2003. The PCAOB invested approximately \$3.6 million to develop a Web-based system for the registration of public accounting firms. The PCAOB also invested approximately \$1.9 million to develop a system to determine and calculate accounting support fees. For each proprietary system, the Board considered the costs and benefits of making or buying the system, taking into account the cost, technology, use, and security. In each instance, the Board found that the benefits of building the system in-house outweighed the benefits of utilizing an existing system.

Financial Review (continued)  
Public Company Accounting Oversight Board  
*Year Ended December 31, 2003*

**OPERATING EXPENSES**

**Program Activities**

The Sarbanes-Oxley Act gives the PCAOB four primary responsibilities to carry out its mission: registration, inspections, standards-setting, and enforcement. These responsibilities represent the program activities for the Board as reflected in the financial statements. Costs associated with these programs include salaries, benefits, and other direct operating expenses relating to the specific activity.

**Supporting Activities**

Supporting activities made up a significant percentage of the PCAOB's 2003 operating expenses as a result of the need to establish a corporate infrastructure to support the Board's program activities. The supporting activities include the offices of the Board members and their staffs, the General Counsel's Office, Public Affairs, Government Relations, Finance, Human Resources, and Administration. The majority of these offices were operational for the better part of the year. Also included in supporting activities are costs relating to information technology operating costs for system maintenance, network support, and depreciation of information technology equipment. At year end, the PCAOB had 118 full-time employees.

Statement of Financial Position  
Public Company Accounting Oversight Board  
*December 31, 2003*

**Assets**

Cash and cash equivalents (Note 2)	\$14,984,233
Accounts receivable, less allowance for doubtful accounts of \$51,270	2,193,903
Prepaid expenses and other assets	635,420
Furniture and equipment, leasehold improvements and technology, net (Note 3)	16,430,878
<b>Total Assets</b>	<b>\$34,244,434</b>

**Liabilities and Net Assets**

**Liabilities**

Accounts payable and other liabilities	\$ 5,417,498
Deferred rent (Note 4)	3,028,134
<b>Total Liabilities</b>	<b>8,445,632</b>

**Net Assets**

Unrestricted	25,798,802
<b>Total Net Assets</b>	<b>25,798,802</b>
<b>Total Liabilities and Net Assets</b>	<b>\$34,244,434</b>

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

Statement of Activities  
Public Company Accounting Oversight Board  
*Year Ended December 31, 2003*

**Changes in Unrestricted Net Assets**

**Operating Revenue**

Fees from issuers (Note 2)	\$52,851,530
Fees from registering accounting firms (Note 2)	2,038,500

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Total operating revenue	54,890,030
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**Operating Expenses**

Program activities (Note 2)	
Inspections and enforcement	6,894,716
Registration	2,445,869
Standard setting	1,496,450
Supporting activities	
Management and administration	13,968,312
Information technology	4,619,068

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Total operating expenses	29,424,415
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<b>Operating Income</b>	<b>25,465,615</b>
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<b>Interest Income and Other</b>	<b>333,187</b>
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<b>Increase in Unrestricted Net Assets</b>	<b>25,798,802</b>
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<b>Unrestricted Net Assets, beginning of year</b>	<b>—</b>
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<b>Unrestricted Net Assets, end of year</b>	<b>\$25,798,802</b>
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The accompanying notes are an integral part of these financial statements.

Statement of Cash Flows  
Public Company Accounting Oversight Board  
*Year Ended December 31, 2003*

<b>Cash Flows from Operating Activities</b>	
Cash received from issuers	\$ 50,895,673
Cash received from registering accounting firms	2,032,250
Interest income and other	333,187
Cash paid to suppliers and employees	(19,177,792)
<hr/>	
Net cash provided by operating activities	34,083,318
<b>Cash Flows from Investing Activities</b>	
Purchases of furniture and equipment, leasehold improvements and technology	(19,099,085)
<b>Cash Flows from Financing Activities</b>	
Advances	20,342,000
Repayment of advances	(20,342,000)
<hr/>	
Net cash provided by (used in) financing activities	—
<b>Net Increase in Cash</b>	<b>14,984,233</b>
<b>Cash and Cash Equivalents, beginning of year</b>	<b>—</b>
<hr/>	
<b>Cash and Cash Equivalents, end of year</b>	<b>\$ 14,984,233</b>
<hr/>	
<b>Reconciliation of Net Income to Net Cash Provided by Operating Activities:</b>	
<b>Increase in Unrestricted Net Assets</b>	<b>\$ 25,798,802</b>
<b>Reconciliation Adjustments</b>	
Depreciation and amortization	2,668,207
Provision for losses on accounts receivable	51,270
Increase in receivables from issuers and registering accounting firms	(2,245,173)
Increase in prepaid expenses	(635,420)
Increase in accounts payable, accrued expenses and employee benefit accruals	5,417,498
Increase in deferred rent	3,028,134
<hr/>	
<b>Net Cash Provided by Operating Activities</b>	<b>\$ 34,083,318</b>

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

# Notes to the Financial Statements

Public Company Accounting Oversight Board

Year Ended December 31, 2003

## 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, nonprofit corporation.

The U.S. Securities and Exchange Commission (the "SEC") has oversight authority over the PCAOB. Among other things, the SEC has the capacity to appoint or remove, for cause, members of the PCAOB's Board, approve the PCAOB's budget and rules, and review appeals of aspects of adverse PCAOB inspection reports and disciplinary actions. In its oversight role, the SEC determined on April 25, 2003, that the PCAOB had the capacity to discharge its responsibilities and enforce compliance with the Act. The PCAOB's initial year of activity primarily focused on the recruitment of qualified professionals, registration of public accounting firms, initial limited inspections of the four largest public accounting firms, the establishment of standards for the auditing profession, and the development of infrastructure to support its ongoing activities. The accompanying financial statements present the activities from January 1, 2003.

## 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 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. Inspections and enforcement, registration, and standard setting are the program activities for the PCAOB. Costs associated with these program activities include salaries, benefits, and other direct operating expenses relating to the above activities. Indirect costs, such as occupancy, are not allocated to program activities, but are included in management and administration under supporting activities.

### Program Activities of the PCAOB

- **Inspections and Enforcement.** The PCAOB conducts a continuing program of inspections of registered public accounting firms to assess their compliance with the Act, the rules of the PCAOB and the rules of the SEC and professional standards, in connection with the firms' performance of audits, issuance of audit reports, and related matters involving issuers, as defined in the Act. The Act grants the PCAOB broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms.
- **Registration.** In accordance with the Act, the PCAOB reviews registration applications and annual reports for public accounting firms that choose to register with the PCAOB. Under the Act and PCAOB rules, an accounting firm that is not registered with the PCAOB may not prepare or issue, or play a substantial role in the preparation or issuance of, any audit report with respect to any issuer.

## Notes to the Financial Statements (continued)

Public Company Accounting Oversight Board

Year Ended December 31, 2003

- **Standard 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.

*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 Accounting Support Fees 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 for that year. Such fees are recognized as revenue in the budget year to which they relate. The amount of fees invoiced to individual entities 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. The PCAOB reports all fees from registering accounting firms as an increase in unrestricted net assets and 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 2003 FASB accounting support fees. The PCAOB earned and was paid \$209,400 from FAF for acting as the collection agent in 2003, which is included in interest income and other in the accompanying statement 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, 2003, the PCAOB had \$304,131 included in cash and cash equivalents related to the FASB. A corresponding \$304,131 was included in accounts payable and other liabilities for amounts due to the FASB.

*Cash and Cash Equivalents.* The term cash and cash equivalents, as used in the accompanying financial statements, includes currency on hand, 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.

*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 3 to 5 years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining term of the current office leases.

*Income Taxes.* The PCAOB is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code. Therefore the accompanying financial statements include no provision for income taxes.

## Notes to the Financial Statements (continued)

Public Company Accounting Oversight Board

*Year Ended December 31, 2003*

**NOTE 3. FURNITURE AND EQUIPMENT, LEASEHOLD IMPROVEMENTS, AND TECHNOLOGY**

These assets consist of the following at December 31, 2003:

Furniture and equipment	\$ 2,570,573
Leasehold improvements	2,598,037
Technology	13,930,475
<u>Total</u>	<u>19,099,085</u>
Accumulated depreciation and amortization	(2,668,207)
	<u>\$16,430,878</u>

**NOTE 4. LEASE COMMITMENTS**

In 2003, the PCAOB occupied office space in Washington, DC, New York City, and Sterling, Virginia, on leases that expire from 2006 to 2013. The leases include provisions for scheduled rent increases over the respective terms.

Rent is being charged to expense using the straight-line method over the respective lease terms. Rent under this method was \$2,342,617 in 2003. Deferred rent expense amounted to approximately \$3,028,134 as of December 31, 2003. Deferred rent is being amortized over the remaining lives of the operating leases.

Minimum rental commitments under the operating leases for the office space as of December 31 are as follows:

Year ending December 31,	
2004	\$ 2,769,023
2005	2,812,385
2006	2,756,464
2007	2,300,821
2008	2,346,838
Thereafter	11,364,699
	<u>\$24,350,230</u>

**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 the employees' accounts were \$412,152 for 2003.

**NOTE 6. 2003 ADVANCES FROM THE DEPARTMENT OF THE TREASURY**

In accordance with the Act, the PCAOB was advanced funds to cover its start-up expenses from The Department of the Treasury totaling \$20,342,000 during 2003. These advances were repaid on September 22, 2003.

Independent Auditors' Report  
Public Company Accounting Oversight Board

To the Board of the Public Company Accounting Oversight Board  
Washington, DC

We have audited the accompanying statement of financial position of the Public Company Accounting Oversight Board (the PCAOB) as of December 31, 2003, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of the PCAOB's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards. 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 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, 2003, and the changes in its net assets and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

*Beers & Carter PLLC*

Washington, DC  
March 18, 2004

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