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The Board is issuing this Release to provide information about the process for determining whether a firm has addressed quality control criticisms to the satisfaction of the Board for purposes of Section 104(g)(2).^{4/} Part I provides an overview of procedural aspects of the process. Part II describes the Board's approach to making the substantive determination.

I. Procedural Aspects of the Board Determination Process

A. Implementing the Act's Incentive-based Approach

Not every Board inspection results in criticism of a firm's quality control system. If a Board inspection does identify a quality control problem of significance, Board inspectors address the matter with the firm, and the final inspection report includes a description of the problem. When that happens, Section 104(g)(2) of the Act provides the firm with an incentive to correct the problem: address the criticism to the Board's satisfaction within 12 months, and the criticism will remain nonpublic; fail to address it to the Board's satisfaction and suffer public exposure of the criticism.^{5/}

Section 104(g)(2) of the Act reflects a legislative policy choice favoring the correction of quality control problems over the exposure of them. Accordingly, the Board takes a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures. Every Board inspection report that includes a quality control criticism alerts the firm to the opportunity to prevent the criticism from becoming public. The inspection report specifically encourages the firm to initiate a dialogue with the Board's Inspections staff about how the firm intends to address the criticisms. The Board provides the opportunity for dialogue so that a firm acting in good faith can receive timely feedback from the staff and enhance its efforts accordingly before the 12-month deadline.

^{4/} As used in this Release, the term "criticism" encompasses what Section 104(g)(2) refers to as "criticisms of or potential defects in the quality control systems of the firm."

^{5/} The Act does not require a firm to address the quality control criticisms to the Board's satisfaction; it merely provides a specific incentive to do so. In the Board's discretion, however, an alleged departure from PCAOB quality control standards can become the subject of a Board disciplinary proceeding. Distinctions between the inspection process and the disciplinary process are discussed in Section II.B below.

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By the 12-month deadline, a firm that seeks to keep the criticism nonpublic may make a submission, pursuant to PCAOB Rule 4009, concerning the ways in which the firm has addressed the criticism (a "Rule 4009 submission").^{6/} Nothing in the Act or the Board's rules requires that a firm initiate any dialogue with the staff or make a Rule 4009 submission. A failure to make a timely Rule 4009 submission, however, constitutes a failure to address the criticism to the Board's satisfaction^{7/} and, by operation of the Board's rules, results in the Board making public the portions of the report describing the criticisms.^{8/}

B. Processing Rule 4009 Submissions

After a firm makes a timely Rule 4009 submission, the Board must determine whether the firm has addressed the criticisms satisfactorily for purposes of Section 104(g)(2) of the Act. Neither the Act nor the Board's rules prescribe a deadline by which the Board will make that determination. Meaningful evaluation of Rule 4009 submissions, particularly larger firms' submissions, may take time and is not likely to be completed immediately after receipt of the submission.^{9/}

^{6/} See PCAOB Rule 4009(a).

^{7/} In other words, one element of addressing a criticism to the Board's satisfaction is affirmatively providing the Board with relevant information concerning the steps taken.

^{8/} See PCAOB Rule 4009(d)(1). The failure to make a submission may have additional consequences, as described in standard language in each inspection report:

[I]f the Firm fails to make any [Rule 4009] submission or demonstration, the Board will assume that the Firm has taken no steps to try to address the criticisms or potential defects. The Board will then consider whether to conduct another inspection of the Firm immediately or whether an investigation or disciplinary proceeding is warranted to determine whether deficiencies in the Firm's quality control systems, or deficiencies in audits performed by the Firm, constitute violations of any laws, rules, or professional standards for which sanctions should be imposed.

^{9/} Because of statutory restrictions, the Board does not publicly disclose any Rule 4009 submission or any Board deliberations concerning the submission. See Section 105(b)(5)(A) of the Act, 15 U.S.C. § 7215(b)(5)(A) (providing that "documents

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In connection with each Rule 4009 submission, the Board receives a recommendation from the Director of the Division of Registration and Inspections,^{10/} which, among other things, takes into account any dialogue between the firm and the Inspections staff during the 12-month period.^{11/} The nature and extent of the dialogue that may be useful during the 12-month period will vary from case to case, depending upon factors such as the nature of the criticism being addressed, the size of the firm's audit practice, and the firm's approach to addressing the deficiency. In some cases, the Board may make its determination on the basis of a firm's written submission in circumstances where there was little or no dialogue between the firm and the staff during the 12-month period. In other cases, the Board may make its determination on the basis of the firm's written submission in circumstances where the firm shaped its remediation efforts through substantial dialogue with the staff. In all cases, the process results in a determination favorable or unfavorable to the firm as to each quality control criticism in the inspection report.^{12/}

1. Board Determinations Unfavorable to the Firm

If, after considering a Rule 4009 submission, the Board determines that a firm failed to address a criticism satisfactorily, the Board will notify the firm.^{13/} Under the Act, a firm that wishes to contest that determination has 30 days to seek review by the

and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents, in connection with an inspection under Section 104 . . . shall be confidential . . .").

^{10/} See PCAOB Rule 4009(a).

^{11/} Dialogue between the firm and the staff during the 12-month remediation period is not a prerequisite to a favorable Board determination. Depending upon the nature of the criticism, however, a firm may often find it useful to take advantage of the opportunity for dialogue.

^{12/} In some circumstances, after considering the firm's written submission, the Board may delay a determination pending follow-up inspection procedures to confirm aspects of the written submission.

^{13/} If a firm fails to make a Rule 4009 submission, the portions of the report describing the criticisms will be made public pursuant to Rule 4009(d) without the Board providing any separate notice to the firm concerning the firm's failure.

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Securities and Exchange Commission ("Commission") before the determination becomes final and is made public.^{14/} If a firm seeks Commission review, the Board delays public disclosure for an additional 30 days or, if ordered by the Commission, such longer time as the Commission may require to complete its review.^{15/}

If the firm does not seek Commission review of the Board's determination, or if the Commission reviews and upholds the Board's determination, that determination will be final for purposes of Section 104(g)(2).^{16/} When a determination unfavorable to the firm becomes final, the Board will make public the relevant, previously nonpublic, portions of the original report. The fact of the Board's unfavorable determination will be indicated on the "Inspection Reports" page of the Board's Web site with a notation next to the firm's name. The publicly available portions of the original report (to which the firm name links) will then include the relevant, previously nonpublic, portions.

2. Board Determinations Favorable to the Firm

If the Board determines that a firm addressed a quality control criticism satisfactorily, the Board will transmit notice of that determination to the firm and provide a copy of that notice to the Commission and the appropriate state regulators. The favorable determination triggers the Section 104(g)(2) requirement that no portion of the report describing the quality control criticism be made public.

The Board does not provide public notice of a favorable determination. This is consistent with the Board's general practice of not publicly indicating, when a report is first issued, whether the nonpublic portion of the report includes a quality control

^{14/} See Sections 104(h)(1)(B) and 104(h)(3) of the Act, 15 U.S.C. §§ 7214(h)(1)(B) and 7214(h)(3), and PCAOB Rule 4009(d)(2).

^{15/} See PCAOB Rule 4009(d)(3).

^{16/} The Act provides that any Commission decision on review of the Board's determination "shall not be reviewable under section 25 of the Securities Exchange Act of 1934 (15 U.S.C. 78y), or deemed to be 'final agency action' for purposes of section 704 of title 5, United States Code." Section 104(h)(2) of the Act, 15 U.S.C. § 7214(h)(2).

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criticism.^{17/} Because the Board does not publicly indicate or confirm the existence of a quality control criticism, the Board does not use the fact that a firm has satisfactorily addressed a quality control criticism as an occasion for publicly disclosing that there was a criticism.^{18/}

II. Substantive Aspects of the Board Determination Process

A. The Meaning of a Board Determination

Both Section 104(g)(2) of the Act and Rule 4009(b) speak in terms of a Board determination as to whether a firm has "addressed" the criticisms to the Board's satisfaction within the 12-month period. A favorable Board determination reflects the Board's assessment that the firm has demonstrated substantial, good faith progress toward achieving the relevant quality control objectives, sufficient to merit the result that the criticisms remain nonpublic. A favorable determination does not necessarily mean that the firm completely and permanently cured any particular quality control defect.

This approach to the meaning of a Board determination flows not only from the language of the Act but also from two practical considerations. First, the Board's approach avoids attempting to manage firms' quality control systems through overly

^{17/} The fact that a portion of an inspection report is nonpublic does not necessarily indicate that the report includes a quality control criticism. In addition to Section 104(g)(2)'s restriction on public disclosure of quality control criticisms, Section 105(b)(5) more generally restricts disclosure of information prepared or received by the Board in connection with an inspection. Accordingly, some reports may include nonpublic portions even though they do not include any quality control criticism. The public portion of the report does not state whether the nonpublic portion includes any quality control criticism. (In an isolated exception to this practice, the public preface to the Board's first four inspection reports, issued on August 26, 2004, generally indicated that each report included a nonpublic discussion of quality control concerns. The public preface included that point, without distinguishing among the four firms, to facilitate understanding of the then-new process of Board inspections and inspection reports.)

^{18/} In the Board's view, nothing in the Act prohibits a firm from making public a Board determination that the firm has satisfactorily addressed a criticism for purposes of Section 104(g)(2). State regulators who receive notice of such determinations from the Board, however, are restricted from making that determination public by Section 105(b)(5)(B)(iv) of the Act.

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prescriptive remedies. The Board's process is based on the proposition that each firm knows best how to manage its operations and to define the specific methods by which it can address a particular quality control criticism. This allows each firm to craft effective remedies based on its particular organizational structure and operations.

Second, with respect to some types of quality control criticisms, a firm may not, realistically, be able to implement practices and procedures that completely achieve the desired objectives in a 12-month period. It is always possible, however, for a firm to demonstrate that it has begun to address the problem seriously, substantially, and in good faith.

For these reasons, the Board focuses its assessment on whether the firm has identified steps suited to the particular objective and is, in good faith, making reasonable progress in implementing those steps.^{19/} A favorable Board determination should not be understood to signify anything more than that.

B. The Effects of a Board Determination

A formal Board determination, whether favorable or unfavorable to a firm, is a determination solely for purposes of Section 104(g)(2) of the Act. A favorable determination should not be understood to be any sort of general seal of approval or to foreclose additional criticism in subsequent inspections. In addition, the Board does not intend, and does not understand Section 104(g)(2) to suggest, that an unfavorable determination estops the firm from contending in other contexts that its quality control system is adequate.

To keep the effects of an unfavorable Board determination in proper perspective, it is helpful to bear in mind important differences between the Rule 4009 process and the Board's disciplinary process. The Rule 4009 process is part of the Board's inspection program, through which the Board takes a supervisory approach to oversight and seeks through constructive dialogue to encourage firms to improve their practices and procedures. A firm that is responsive to the supervisory approach may disagree

^{19/} In some cases, a firm might address a Board quality control criticism by demonstrating to the Board's satisfaction that the problem identified by the Board was not in fact a systemic problem, capable of being addressed through a systemic solution, but, rather, involved relatively isolated departures from the firm's normal practice. In those circumstances, the Board would consider the quality control criticism to have been satisfactorily addressed by the firm's showing.

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with a particular Board assessment of the firm's quality controls, but may nevertheless respond by engaging constructively and working to address the Board's concerns, rather than by aggressively contesting the assessment.

Overall, both the effectiveness and the efficiency of the Board's programs are enhanced when firms opt for constructive engagement rather than an adversarial approach. The Board therefore generally seeks, in its inspection program, to encourage constructive engagement, rather than to put firms in a position where they will perceive that their self-interest is better served by an adversarial and confrontational posture. As the Board has previously explained,

the Board is sensitive to the fact that a violation of professional standards cannot legally be established until certain procedures have been followed. In addition, the Board is sensitive to the fact that a firm's cooperation in constructively addressing an issue in a supervisory regulatory context is not the same thing as the firm admitting, for any legal purpose, a fact or a violation. For these reasons, the Board emphasizes that an inspection report's descriptions of departures from professional standards are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability.^{20/}

That is not to say, however, that when a firm fails to address appropriately an inspection report's quality control criticism, publication of the criticism is in every case the end of the matter. If the perceived quality control deficiency and the firm's inadequate response warrant additional action, the Board may institute disciplinary action against the firm for failing to comply with PCAOB standards.

Unlike the Board's inspection process, the Board's disciplinary process is adversarial in nature. The disciplinary process carries the prospect of a range of sanctions, including significant money penalties and the possible suspension or revocation of registration.^{21/} In the disciplinary context, the Act provides the firm with

^{20/} See Statement Concerning The Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (Aug. 26, 2004), at 7 (on the Board's Web site at www.pcaobus.org/Inspections).

^{21/} See Section 105(c)(4) of the Act, 15 U.S.C. § 7215(c)(4), and PCAOB Rule 5300.

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certain procedural rights, including notice and an opportunity to be heard, adjudication on the basis of evidence adduced in an adversarial proceeding, and a right of appeal not only to the Commission but also (after any Commission decision) to the federal court of appeals.^{22/}

C. Quality Control Criticisms – A Note on Differences Between Firms of Different Sizes

The Board issues inspection reports throughout the year, and, consequently, different firms' 12-month remediation periods run at different times. Quality control criticisms that are made public in a particular firm's report relate to that firm alone and should not be generalized to other firms or to categories of firms. To the extent that quality control criticisms become public, however, it may be useful to bear in mind the reasons that the nature of the quality control discussions in reports on smaller firms will generally differ significantly from the nature of those discussions in reports on larger firms.

The Board's quality control standards recognize that the nature, extent, and formality of the quality control policies and procedures appropriate for any particular firm must take into account various factors, including the size of the firm.^{23/} Board quality control assessments also take these factors into account. In inspections of smaller firms, quality control criticisms may often arise less from a review of formal policies and procedures and more from inferences drawn from deficiencies in the performance of audits. An inspection report's articulation of those criticisms is often in standard, fairly general terms, with the goal of focusing the firm on improving those aspects of its work on audits.

The quality control policies and procedures at larger firms are typically far more complex, extensive, and formal than those at smaller firms. Board inspection

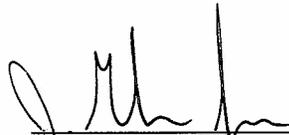
^{22/} See Sections 105(c) and 107(c) of the Act, 15 U.S.C. §§ 7215(c) and 7217(c).

^{23/} See PCAOB Interim Quality Control Standards, QC Section 20.04 (providing that "[t]he nature, extent, and formality of a firm's quality control policies and procedures should be appropriately comprehensive and suitably designed in relation to the firm's size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of the firm's practice, and appropriate cost-benefit considerations").

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procedures are correspondingly more extensive, and inspection report discussions of those quality control systems are usually set out in extensive and specific terms. Those critiques tend to focus not only on audit performance issues but also on how the firm designs and implements other aspects of its business that bear on the quality of its audits. Processes relating to such things as the firm's internal inspections, evaluation and compensation of partners, compliance with independence requirements, establishment and internal communication of policies and procedures, and client acceptance and retention, all tend to call for much more formal and detailed approaches in larger firms than in smaller firms. Board inspection critiques of those systems are correspondingly more detailed.

ISSUED BY THE BOARD.



J. Gordon Seymour
Secretary

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