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OBSERVATIONS ON THE INITIAL)
IMPLEMENTATION OF THE PROCESS)
FOR ADDRESSING QUALITY CONTROL)
CRITICISMS WITHIN 12 MONTHS)
AFTER AN INSPECTION REPORT)
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PCAOB Release No. 104-2006-078
March 21, 2006

In August 2004, the Public Company Accounting Oversight Board ("PCAOB" or "Board") issued its first inspection reports – reports on initial limited inspections of Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. Pursuant to Section 104(g)(2) of the Sarbanes-Oxley Act of 2002 ("the Act"), the Board did not make public any portions of those reports that dealt with criticisms of a firm's quality control systems.^{1/} Both the Act and the Board's rules, however, made plain that the Board would publicly disclose such criticisms if the firm failed to address them to the Board's satisfaction within 12 months.^{2/}

Aware of the prospect of such disclosure, each firm engaged in substantial dialogue with the Board's staff during the 12-month period concerning the firm's efforts to address the criticisms, and each firm made a timely submission, pursuant to PCAOB Rule 4009, concerning those efforts ("Rule 4009 submission").^{3/} With respect to each of

^{1/} 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."

^{2/} See Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2); PCAOB Rule 4009.

^{3/} The Board has elsewhere described the process relating to a firm's efforts to address quality control criticisms in the 12-month period. See *The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports*, PCAOB Release No. 104-2006-077 (March 21, 2006) ("*The Determination Process*"). The Board strongly encourages review of *The Determination Process* as background for the discussion in this release.

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those Rule 4009 submissions, the Board determined that the firm addressed the quality control criticisms to the Board's satisfaction for purposes of Section 104(g)(2) of the Act.^{4/} As a result, under the Act, "no portions of the inspection report that deal with [the quality control criticisms] shall be made public."^{5/} Because those determinations mark the end of the first 12-month remediation period, however, it may be useful to provide insights into the process and its effects, including a general summary of some of the types of steps taken by firms to address the Board's quality control concerns.^{6/}

The Board's initial experience with the 12-month remediation process generally validates the premise of the approach set out by Congress in Section 104(g)(2) of the Act. That legislative approach rested on the hypothesis that firms could be genuinely motivated by the prospect of keeping the Board's quality control criticisms confidential. The Board's initial experience with the larger firms supports that hypothesis. Moreover, the firms were responsive to the Board's supervisory model, taking the initiative to engage constructively with the staff in an ongoing dialogue toward a result satisfactory to the Board, rather than emphasizing points of disagreement and taking an adversarial approach.

^{4/} As described in *The Determination Process*, it will not be the Board's usual practice to disclose publicly that a firm has addressed a criticism to the Board's satisfaction, since doing so has the effect of disclosing that there was a criticism in the first place. In an isolated exception, however, because the Board has previously indicated that each of the initial four inspection reports included a nonpublic discussion of quality control concerns, the Board is publicly disclosing the determination that each firm addressed those criticisms to the Board's satisfaction for purposes of Section 104(g)(2) of the Act.

^{5/} Section 104(g)(2) of the Act, 15 U.S.C. § 7214(g)(2).

^{6/} Information received or prepared by the Board in connection with an inspection, including information in a Rule 4009 submission, is subject to confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Act. Under the Board's Rule 4010, however, the Board may publish summaries, compilations, or general reports concerning such information, provided that no such published report may identify the firm or firms to which any quality control criticisms in the report relate, unless that information has previously been made public in accordance with Rule 4009, by the firm or firms involved, or by other lawful means. Accordingly, the summary presented here does not identify any particular firm in connection with any particular steps.

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As a result of the process, the Board believes that those firms have crafted and undertaken important steps that, if conscientiously implemented, will have beneficial effects on audit quality. Several of these steps are summarized below. Some of the items summarized here pertain to more than one firm, but the list is a compilation, not a description of the efforts of any single firm. In some cases, the items summarized here reflect varying approaches among firms to address similar, but not necessarily identical, Board criticisms. These summaries should be understood in the context of the Board's approach to the Rule 4009 process as described in the Board's separate release on the process^{7/} – i.e., reflecting a firm's efforts to address specific criticisms within the organizational and operational structure of the particular firm – rather than being understood as something like a Board-endorsed list of "best practices."^{8/}

A. Audit Performance

In each Board inspection, the inspection team selected certain audits performed by the firm and reviewed various aspects of those audits. In addition to identifying problems particular to an individual audit, this review contributed to the Board's assessment of the firm's quality control system. That assessment rests not only on review of policies and procedures in the various other categories described below, but also on inferences that can be drawn from respects in which the firm's system failed to assure quality in the actual performance of engagements. Where appropriate, Board inspection reports articulate quality control criticisms based on those inferences. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- changing the organizational structure so that responsibility for ethics, independence, client acceptance, and audit quality monitoring is separated from responsibility for audit operations and business

^{7/} See *The Determination Process* at 7.

^{8/} The Board's first four inspections, to which the steps described here relate, were conducted in the Board's first year and have been characterized by the Board as "limited" inspections to lay a foundation for the subsequent, more probing inspections that the Board has since conducted. The public versions of the reports on those inspections are available on the Board's Web site at www.pcaobus.org/Inspections/Public_Reports/2003. The public versions do not include the Board's quality control discussions, but they do describe the inspection procedures performed by the Board's inspection staff in subject matter areas corresponding to the categories of steps summarized here.

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development, with a separate and direct reporting line to the firm Chairman;

- establishing an internal network to coordinate second tax partner reviews of income tax provision work papers on selected audits;
- adding internal guidance indicating that, when reviewing contracts in the course of an audit, contracts exhibiting characteristics that may be associated with greater risks of material misstatement should be read by more experienced audit personnel, and adding guidance related to documenting consideration of whether significant contracts exhibit those characteristics;
- adding a new requirement to include, in the audit documentation, evidence of engagement partner and manager involvement in, and review of, certain detailed work papers;
- communicating strong, firm-wide messages from firm leadership concerning the importance of adequate audit documentation and its contribution to improved audit quality, and reinforcing the message by factoring significant documentation deficiencies into the partner evaluation and compensation process; and
- adding various topics to in-house audit partner and manager training curricula.

B. Internal Inspections

Each Board inspection included a review of aspects of the firm's own internal program for inspecting the performance of audits by its personnel. The objectives of the Board's inspection procedures in this area were to evaluate the effectiveness of the firm's internal inspection program in enhancing audit quality and to observe and test the conduct of the internal inspection program in selected practice offices. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- increasing the number of engagements subject to internal inspection;
- making changes to affect the internal perception of participation as a reviewer in the firm's internal program by, for example, making clear that

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participation in the program is an indication that an individual is viewed as a top performer and that it is an important developmental step in the career path of any senior manager who aspires to partnership, rather than being treated as a distraction from other responsibilities viewed as more important to advancement in the firm;

- changing the program from one based on voluntary participation by many individuals in addition to their other duties, to one involving a group of individuals dedicated to internal inspections on a full-time basis, with no conflicting duties to dilute their effectiveness as internal reviewers;
- creating a more specifically trained and more experienced reviewer pool, with oversight from the national office, to provide more effective and consistent internal reviews;
- increasing the assignment of specialists to internal inspection teams;
- increasing the frequency of internal inspection of work performed by partners who serve as engagement partners on public company audits; and
- making the cycle of internal inspections less predictable, and providing less advance notice of the selection of an engagement for review.

C. Evaluation and Compensation of Partners

Each Board inspection included a review of aspects of the firm's approach to evaluating the performance of, and setting compensation for, the firm's audit partners. The objectives of the inspection procedures in this area included (1) assessing the relative weight the firm gives to marketing as opposed to audit quality and technical competence in admitting new partners, measuring partner performance, establishing partner compensation, assigning responsibilities to partners, and disciplining partners, and (2) assessing whether the design of the measurement, evaluation, and compensation processes as documented and communicated could be expected to

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achieve the objective of promoting audit quality. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- revising the factors and forms used in the annual evaluation of audit partners to increase or make clearer the importance of audit quality relative to other factors;
- revising the factors and forms used in considering promotion to partnership to increase or make clearer the importance of technical auditing capabilities;
- expanding the involvement of national office professional practice personnel (with regional professional practice responsibilities) in evaluating and documenting the technical performance of audit partners in their regions;
- formalizing and strengthening a program for consistent disciplinary and remedial action plans for partners found to be deficient in performing audits; and
- centralizing control of, and formulating guidance concerning the required contents of, files relating to partner evaluations, and a concurrent effort to locate missing information that should be in those files.

D. Independence

Each Board inspection included a review of aspects of the firm's policies and procedures relating to the firm's compliance with independence requirements. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- formalizing processes for entering into certain kinds of business arrangements, agreements, and alliances, including required consultation with the national office, and for reevaluating the arrangements from an independence perspective on an annual basis;
- expanding requirements so that an engagement team must submit documentation to the national office independence group on all engagement-specific independence consultations, rather than just for a certain subset of those consultations;

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- establishing a new centralized database for internal independence consultations that requires engagement teams, the national independence office, and others (such as partners in affiliated non-U.S. firms) to enter information and document the resolution of consultations; and
 - issuing an independence manual and resource guide to provide in one place key internal policies on independence and related matters.
- E. Establishment and Communication of Policies, Procedures, and Methodologies

Each Board inspection included a review of aspects of the firm's processes for establishing and communicating audit policies, procedures, and methodologies, including training. The objectives of the inspection procedures in this area were to evaluate (1) whether the firm's processes could be expected to promote audit quality and enhance compliance, (2) changes in firm audit policies, and (3) the content of the firm's training on the then-recently issued Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- increasing internal requirements related to documenting the reasons for using alternative bases (other than net income from continuing operations) for determining materiality measures used in planning the audit;
- revising a policy manual to include guidance on quantitative and qualitative factors to consider when determining materiality measures used in planning the audit;
- enhancing systems to minimize the possibility of improper manipulation of dates relating to the creation and archiving of work papers;
- imposing stricter requirements for the physical logging in of hard copy audit documentation files in a record center on or before the documentation completion deadline; and
- increasing internal requirements related to documenting internal consultations within the firm in the course of an audit.

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F. Acceptance and Continuance of Clients

Each Board inspection included a review of aspects of the firm's client acceptance and retention policies and procedures. The objective of the inspection procedures in this area was to assess whether the firm's policies and procedures reasonably assure that the Firm (1) is not associated with issuers whose management lacks integrity, (2) undertakes only engagements within its professional competence, and (3) appropriately considers the risks involved in accepting and retaining a client. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- imposing stricter documentation and document retention policies in connection with decisions to accept or retain audit clients including, for example, mandatory documentation of all risk conditions identified in assessing whether to accept or retain the client; and
- imposing new requirements that client continuance decisions be subject to review by other partners sufficiently removed from the engagement team.

G. Supervision of Foreign Affiliates

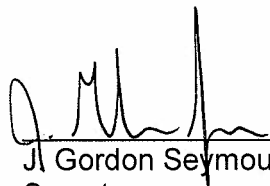
Each Board inspection included procedures to begin forming a basis on which to evaluate the processes the firm uses to ensure that the audit work performed by its foreign affiliates on the foreign operations of the firm's U.S. clients is reliable and in accordance with the standards established by the Board. Steps that emerged from the Rule 4009 process to address criticisms in this area include –

- formalizing and making more rigorous the process through which the firm satisfies itself of the technical competence, in U.S. GAAP and PCAOB standards, of a non-U.S. affiliate's personnel participating in an audit of a U.S. issuer;
- adding a requirement that both the non-U.S. affiliate and the U.S. engagement team evaluate the experience, training, and skills of the non-U.S. personnel with respect to U.S. GAAP and PCAOB standards; and

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- providing an increased emphasis on communication with non-U.S. affiliates about the importance of compliance with deadlines for completion of annual independence questionnaires.

ISSUED BY THE BOARD.



J. Gordon Seymour
Secretary

March 21, 2006