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COMPLIANCE WITH AUDITING AND	)
RELATED PROFESSIONAL PRACTICE	)
STANDARDS	)
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ADVISORY GROUPS	)
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PCAOB Release No. 2003-009  
June 30, 2003  
PCAOB Rulemaking  
Docket Matter No. 004

Summary: After public comment, the Public Company Accounting Oversight Board ("Board" or "PCAOB") has adopted a Rule relating to compliance with the Board's auditing and related professional practice standards and a Rule relating to the formation of advisory groups. Specifically, the Board has adopted Rule 3100, and a related definition that would appear in Rule 1001, and Rule 3700. Rule 3100 generally requires all registered public accounting firms to adhere to the Board's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer (as defined in the Sarbanes-Oxley Act of 2002 (the "Act")) and in their auditing and related attestation practices. Rule 3700 governs the formation, composition and role of one or more advisory groups to assist the Board in formulating new auditing and related professional practice standards for registered public accounting firms. The Board will submit these Rules to the Securities and Exchange Commission ("Commission" or "SEC") for its approval pursuant to Section 107 of the Act. These Rules will not take effect unless approved by the Commission pursuant to Section 107 of the Act. This Release also provides additional guidance regarding the number, size and composition of advisory groups and addresses certain qualifications that the Board may consider in selecting advisory group members and the terms and conditions of membership. Further, it provides guidance about the advisory group meetings, agendas, role of members and procedures that the Board believes is important to the functioning of advisory groups.



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Public

Comment: The Board released for public comment proposed Rules on the establishment of auditing and other professional standards on April 18, 2003. The Board received 22 letters of comment.

Board

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Section 103(a)(1) of the Act directs the Board to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. Similarly, Section 103(b) authorizes the Board to establish such rules as may be necessary or appropriate to implement the auditor independence requirements in, or as authorized under, Title II of the Act. While Section 103(a)(4) directs the Board to convene such expert advisory groups as may be appropriate to aid in standards-setting, it nevertheless affords the Board considerable discretion in determining the procedures by which it will develop and adopt auditing and related professional practice standards.<sup>1/</sup>

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<sup>1/</sup> The auditing and related attestation standards, quality control standards, and ethics standards over which the Board has authority under Section 103(a) of the Act, and the independence rules the Board is authorized to adopt under Section 103(b), are collectively referred to in this Release as "auditing and related professional practice standards." This term is defined in Rule 1001(a)(viii). The Board's proposed Rules and Release used the term "professional auditing standards." As discussed in more detail in Appendix 2 to this Release, because a number of commenters found this term confusing, the Board has decided to use the term "auditing and related professional practice standards" (hereinafter, "Standards").

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This Release announces the adoption of Rule 3100 (and a related definition) and Rule 3700. Rule 3100 requires all registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, and its independence standards. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, which may be convened to aid in the Board's standards-setting process. In addition, as set forth in more detail below, the Board has determined to convene, at this time, one standing advisory group (the "SAG") to assist it in performing its standards-setting responsibilities.

Section A of this Release discusses the adoption of Rule 3100. Section B discusses the adoption of Rule 3700, and the establishment of the SAG and ad hoc task forces. The text of Rule 3100 (and a related definition) and Rule 3700 and a detailed discussion of the Rules are provided in Appendices 1 and 2 hereto, respectively.

The Board has reviewed all of the public comments received on the Rules as proposed in Release No. 2003-005. In response to these comments, Rule 3100 (and a related definition) and Rule 3700, as finalized, both clarify and modify certain aspects of the proposed Rules. Most importantly, the revisions to the original proposal are as follows –

- Instead of using the term Professional Auditing Standards as originally proposed, the defined term in Rule 1001 has been changed to Auditing and Related Professional Practice Standards;
- Rule 3700(c), Selection of Members of Advisory Groups, has been revised to clarify that the Board will accept nominations to the SAG, including self-nominations, from any person or organization rather than including a non-exclusive list of specific groups; and
- Rule 3700(e), Ethical Duties of Advisory Group Members, has been revised to make EC10 of the Board's Ethics Code applicable to members of the SAG with respect to any private publication or public statement

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about the Board or any advisory group or any of the activities of the Board or any advisory group.<sup>2/</sup>

A more detailed analysis of the Board's response to the comments on the proposed Rules is included in Appendix 2. The Board's Rules will be submitted to the Commission for approval. Pursuant to Section 107 of the Act, Board Rules do not take effect unless approved by the Commission.

A. Compliance with the Board's Auditing and Related Professional Standards

Section 103(a) of the Act directs the Board, by rule, to establish auditing and related attestation standards, quality control standards, and ethics standards "to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." Section 103(b) of the Act also directs the Board to establish independence standards to implement, or as authorized under, Title II of the Act.<sup>3/</sup>

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<sup>2/</sup> See PCAOB Release No. 2003-008 (June 30, 2003) which includes the entire text of the Board's Ethics Code.

<sup>3/</sup> See also Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on S. 2673, S. Rep. No. 107-205 (July 26, 2002) ("The Committee has concluded that the Board's plenary authority in this area is essential for the Board's effective operation, a position taken during the hearings by a number of witnesses..."). Board Rules adopting or modifying auditing and related professional practice standards require approval by the Commission. In addition, the Board recognizes that the Commission may also establish professional standards applicable to accountants that practice before it and audit reports filed with it and that the Commission has the authority to institute proceedings to amend the Board's Rules, including those that establish auditing and related professional practice standards. See Sections 2(a)(10), 3(c)(2), and 107(b)(5) of the Act.

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As a corollary to the Board's exclusive, statutory authority to establish and amend Standards, all public accounting firms that are registered with the Board must comply with the Board's Standards. While this requirement is implicit in the Act, the Board has codified the obligation of registered firms to comply with the Board's Standards in Rule 3100. Any registered public accounting firm or person associated with such a firm that fails to adhere to applicable Board Standards may be the subject of a Board disciplinary proceeding in accordance with Section 105 of the Act.<sup>4/</sup> In general, the Board's Standards will apply to registered public accounting firms and their associated persons in connection with their audits of (and related attestations concerning) the financial statements of issuers, as defined in Section 2(a)(7) of the Act, and those firms' auditing and related attestation practices. A number of commenters suggested that this Rule was either beyond the Board's authority or would create the impression that it applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board has decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all *applicable* Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.

Authorities other than the Board may nevertheless require that accounting firms or individual auditors comply with the Board's Standards in the conduct of audits of (or

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<sup>4/</sup> In addition, the Act provides that any violation of the Board's Rules is to be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq., or the rules and regulations issued thereunder, and any person violating the Board's Rules "shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange] Act or such rules or regulations." Section 3(b)(1) of the Act.

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attestations concerning) the financial statements of non-issuers.<sup>5/</sup> In that event, those authorities may enforce the Board's Standards pursuant to their own processes.

B. Establishment of Advisory Groups and Ad Hoc Task Forces

While the Board will, by rule, establish Standards, it recognizes that the development of such Standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements, and others will have the opportunity to participate. To this end, as discussed in PCAOB Release No. 2003-005 (April 18, 2003), the Board intends to provide for a public comment process on proposed standards.<sup>6/</sup> The Board's staff will, of course, be actively involved in the standards-setting process, but the Board also encourages proposals and recommendations on its standards-setting agenda and standards development projects from the public. Moreover, in order to obtain the advice of a broad range of experts, the Board has determined to form an advisory group, the SAG, which may be divided into sub-groups by the Board if the need for specialized advice arises. Finally, the Board may also establish one or more ad hoc task forces to assist the staff with the drafting of technical language, among other things.

1. Authority

Section 103(a)(4) of 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

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<sup>5/</sup> Cf. Section 209 of the Act (stating that "[i]n supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable...").

<sup>6/</sup> In response to PCAOB Release No. 2003-005, the Board received several comments relating to the process by which the Board will establish standards. While this release is intended to address only the adoption of Rules 3100 and 3700, the Board will nevertheless take these comments into consideration in its standards-setting work.

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section." The Board has decided initially that it is likely to exercise this authority by convening the SAG to participate in the standards-setting process. Rule 3700 addresses the formation, composition, and other basic matters concerning advisory groups, including the SAG.

## 2. Role, Size and Composition

The role of the SAG will be to assist the Board in *reviewing* existing Standards, in *evaluating* proposed Standards recommended by Board staff, Board-formed technical task forces or others and *recommending* to the Board new or amended Standards. The role of the SAG will not ordinarily include technical drafting (which will be performed by the Board's staff, with the assistance of ad hoc task forces, when necessary). Instead, the Board will look to the SAG to provide advice and insight as to the need to formulate new Standards or change existing Standards and opinions on the impact of proposed new or changed Standards.

The Board contemplates that the SAG initially will have approximately 25 members. As noted above, the Board may, based on the circumstances of particular projects, prior to or after the formation of the SAG, form ad hoc task forces of specially qualified persons selected by the Board to assist it with specific projects. Members of any appointed ad hoc task force may or may not be members of the SAG.

The SAG will be composed of individuals with a variety of backgrounds, including practicing auditors, preparers of financial statements, investors (both individual and institutional), and others.<sup>7/</sup> In order to achieve this diversity, the Board expects that no one field of expertise will predominate among the SAG membership. Although SAG members may be employed or otherwise affiliated with particular organizations, the Board expects SAG members to serve in their individual capacities and not to serve as representatives of particular interests, groups or employers.

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<sup>7/</sup> The Board also anticipates appointing individuals from academia and state accounting regulators, among others, to the SAG.

3. Nominations of SAG Members

In determining appointments to the SAG, the Board intends to solicit nominations, including self-nominations. Interested parties will have 45 days from the date of the Board's Notice ("Notice") to the public to submit nominations on a form which will be provided in the Notice. Interested parties who have submitted nominations prior to the publication of the Notice, will be sent nomination forms for completion at the time of publication of the Notice.

4. Qualifications

In evaluating nominations for the SAG, the Board will seek individuals with an interest in the quality of the audits of public companies. The Board may also consider certain factors in determining SAG appointments including but not limited to the following –

- (a) SAG members will be individuals of integrity, with an understanding of the responsibilities for and the nature of financial disclosure required under the securities laws and the obligations of accountants with respect to the preparation of and issuance of audit reports with respect to such disclosures; and
- (b) SAG members will have a working knowledge of one or more of the following subjects and a general understanding of the remaining subjects –
  - generally accepted auditing standards (as developed by previous auditing standards setting bodies and adopted by the Board as Standards and, in the future, as set from time to time by the Board);
  - generally accepted accounting principles;
  - the creation, audit or analysis of public financial statements;
  - public company corporate governance; and

- other fields that the Board deems to be relevant.

5. Term

Unless the appointment is revoked for cause, as determined by the Board, or unless the SAG member voluntarily resigns from the SAG, membership on the SAG will be for a term of two years; provided, however, that approximately 50 percent of the initial members will be appointed for a three-year term to assure continuity. Members will not be limited in the number of terms that they may serve.

6. Conditions of Membership

Rule 3700(d) specifically states that members of the SAG will serve in their individual capacities and therefore may not delegate their duties, including attendance at meetings, as SAG members. In addition, each appointee to the SAG shall agree in writing to the following "conditions of membership" in order to avoid potential conflicts of interest and to assure that the Board's standards-setting agenda is met –

- (a) to serve on a voluntary basis without compensation from the Board;<sup>8/</sup>
- (b) to seek constructive resolutions to issues raised by the Board for the SAG;
- (c) to act in the public interest in his or her individual capacity and not as a representative of any constituency;
- (d) to attend at least 75 percent of all SAG meetings;<sup>9/</sup>

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<sup>8/</sup> SAG members shall be entitled to reimbursement for documented reasonable travel expenses relating to participation in official SAG meetings or other SAG activities.

<sup>9/</sup> Attendance may be in person or by telephone or teleconference. SAG members who fail to participate in the minimum number of meetings shall be subject to removal by the Board unless excused from attendance by the Chair of the SAG for good reason.

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- (e) to agree to spend, at an expected minimum, between 50 and 100 hours per year on SAG matters or such reasonably greater amount of time as may be necessary to achieve the goals of the SAG and the Board;<sup>10/</sup>
- (f) to refrain from using his or her position on the SAG to influence Board members or Board staff on matters directly affecting that SAG member or his or her employer, business partners or clients;<sup>11/</sup>
- (g) to recuse himself or herself, or otherwise withdraw from, consideration of any matter before the SAG or the Board directly affecting such SAG member, his or her employer, business partners or clients. If recusal or withdrawal is not practical in either such member's or the Board's opinion, such SAG member shall resign from the SAG;<sup>12/</sup>

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<sup>10/</sup> During the first year of the SAG, members may expect to spend more than the minimum number of hours on SAG matters.

<sup>11/</sup> SAG members are not precluded from appearing or practicing before the Board regarding matters generally affecting all issuers or registered public accounting firms, including, indirectly, the member, his or her employer, business partners or clients. Accordingly, a SAG member who is employed by a registered public accounting firm would be permitted to be involved in preparing a comment on a Board rule proposal that generally affects all issuers or registered public accounting firms.

<sup>12/</sup> Matters generally affecting issuers or registered public accounting firms, even though affecting the SAG member, his or her employer, business partners or clients, shall not require the member to recuse or withdraw him or herself from consideration of the matter or to resign from SAG. The Board expects that most standards-setting projects will affect issuers (or categories of issuers) and registered public accounting firms and their associated persons in a generally similar manner; however, if a standard would have a unique or disproportionate effect on a particular issuer or firm, a SAG member employed by that issuer or firm would be required under Rule 3700 to recuse himself or herself.

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- (h) to be bound by EC3, EC8(a), EC9, and, with respect to any private publication or public statement regarding the Board or the SAG or any of the activities of the Board or the SAG, EC10 of the Board's Ethics code;<sup>13/</sup>
- (i) to annually certify his or her continuing compliance with "the conditions of membership;" and
- (j) to agree to any such other provisions that the Board may deem necessary to avoid even the appearance of a conflict of interest.

7. Meetings and Board Relations

The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards who will be a non-voting member of the SAG. The Board will approve the agenda for all annual, semi-annual or quarterly SAG meetings as set forth below. Agenda items may also be added where the Board determines that the assistance of the SAG is required in response to emerging issues or problems. The Chair will be responsible for preparing the meeting agenda, organizing and overseeing meetings, conference calls and related activities, acting as the general liaison to the Board and finalizing all submissions to the Board based on the SAG recommendations.

The SAG will hold an annual meeting to discuss the agenda presented to the SAG on the annual standards-setting process and related matters. The SAG will also hold a semi-annual meeting. Both the annual and the semi-annual meetings will be open to the public. Meetings of the SAG may also be held, at the direction of the Board or the Chair, during the intervening quarters. In addition, at the direction of the Chair, monthly meetings of the SAG may be held, by video or teleconference, for the Board's staff to report on new issues raised by the Board for the SAG's consideration and to

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<sup>13/</sup> In PCAOB Release No. 2003-008 (June 30, 2003), the Board clarified that for purposes of applying EC8(a) to SAG members, the SAG members shall not be considered to lack independence or objectivity with regard to SAG matters merely because they (or their employer, business partners or clients) are subject to the direct or indirect oversight of the Board.

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discuss the status of pending issues. Final decisions on recommendations to the Board and related activities will be conducted at the annual, semi-annual, or other open meeting of the SAG.<sup>14/</sup> The meetings held in the quarters between the annual and semi-annual meeting, if any, and the monthly meetings will not generally be open to the public.

If so directed by the Chair of the SAG, the SAG may convene hearings, roundtable discussions or other fact-finding activities designed to assist the SAG in the development of recommendations on new or amended Standards or other recommendations to the Board.

Decisions on whether a recommendation should be made to the Board will be by a majority of the SAG members present in person or by video or teleconference. Recommendations from the SAG will be presented to the Board at an open meeting of the Board. Such recommendations will be provided in writing, including dissenting opinions, if any, by SAG members. The Board retains the exclusive authority to adopt, modify, or reject any SAG recommendation, in its sole discretion, in order to protect investors by improving the fairness and reliability of corporate disclosures as set forth in the Act.

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<sup>14/</sup> The Board expects the SAG to make decisions in an efficient and speedy manner. To this end, the SAG need not defer decisions on recommendations for the annual or semi-annual open meetings. Rather, at the direction of the Chair, the SAG may make decisions on recommendations at any meeting, so long as it is open to the public in some manner, including, at the direction of the Chair, telephonically.



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On the 30th day of June, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Acting Secretary

June 30, 2003

APPENDICES –

1. Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups
2. Section-by-Section Analysis of Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups



**Appendix 1 – Rules Relating to  
Auditing and Related Professional Practice Standards and Advisory Groups**

**RULES OF THE BOARD**

**SECTION 1. GENERAL PROVISIONS**

**Rule 1001. Definitions of Terms Employed in Rules.**

When used in the Rules, unless the context otherwise requires:

**(a)(viii) Auditing and Related Professional Practice Standards.**

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

**SECTION 7. PROFESSIONAL STANDARDS**

**Part 1 – General Requirements**

**Rule 3100. Compliance with Auditing and Related Professional Practice Standards.**

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.

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## **Part 7 – Establishment of Professional Standards**

### **Rule 3700. Advisory Groups.**

#### **(a) Formation.**

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

#### **(b) Composition.**

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas –

- (1) accounting;
- (2) auditing;
- (3) corporate finance;
- (4) corporate governance;
- (5) investing in public companies; and
- (6) other areas that the Board deems to be relevant to one or more auditing or related professional practice standards.

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**(c) Selection of Members of Advisory Groups.**

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

**(d) Personal Membership.**

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

**(e) Ethical Duties of Advisory Group Members.**

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

**(f) Ad Hoc Task Forces.**

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.

**Appendix 2 – Section-by-Section Analysis of Rules Relating to Auditing and Related Professional Practice Standards and Advisory Groups**

**Rules Relating to Auditing and Related Professional Practice Standards**

The Rules relating to auditing and related professional practice standards consist of Rule 3100, plus a new definition that appears in Rule 1001. Each of the Rules, and the new definition, is discussed below.

**Rule 1001 – Definitions of Terms Employed in Rules.**

Rule 1001 contains definitions of terms used in the Board's Rules.

*Auditing and related professional practice standards*

Rule 1001(a)(viii) defines "auditing and related professional practice standards" as the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

The Board had proposed to use "professional auditing standards" as the term defined in this provision. Several commenters expressed concern that characterizing attestation, quality control, ethical, and independence standards as "professional auditing standards" would confuse people as to the defined term's meaning. To address these concerns, the Board has chosen to use the term "auditing and related

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professional practice standards" as the defined term for the standards established or adopted by the Board under Section 103 of the Act. The Board has used the longer term "auditing and related professional practice standards," rather than the shorter "professional standards," because the term "professional standards" is defined otherwise in Section 2(a)(10) of the Act. The term "auditing and related professional practice standards" is similar to that portion of the definition of the term "professional standards" that appears in Section 2(a)(10)(B) of the Act. (Hereinafter in this Section-by-Section Analysis, auditing and related professional practice standards shall be referred to as "Standards.")

In addition, the Board's proposed definition was based on a portion of the definition of "professional standards" in Section 2(a)(10)(B) of the Act. For purposes of clarity, the Board has modified this definition slightly to track more closely the description of the standards the Board will set in Section 103(a)(1) of the Act. The definition still includes any other type of standard provided for in the definition of "professional standards" in Section 2(a)(10)(B) of the Act that the Board establishes or adopts under Section 103 of the Act. Accordingly, the definition, as revised, covers the same scope of standards as the Board's proposed rule.

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**Rule 3100 – Auditing and Related Professional Practice Standards Applicable to Registered Public Accounting Firms.**

Rule 3100 provides that a registered public accounting firm and its associated persons must comply with all applicable Standards.<sup>1/</sup> This Rule is intended to codify the obligation of registered public accounting firms and their associated persons to comply with applicable Standards and to ensure that the Board's Standards are enforceable.

A number of commenters suggested that this Rule was either beyond the Board's authority or would create the impression that the Rule applied to areas outside the Board's authority. To address these concerns, commenters suggested adding language about the scope of the Board's authority to Rule 3100. After considering these comments, the Board has decided to adopt the Rule as proposed.

The Board recognizes its responsibility to oversee the audits of issuers, as that term is defined in the Act, and does not intend to suggest that registered public

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<sup>1/</sup> The Board's proposed rule included a note to clarify that proposed Rule 3100 was intended to apply to those public accounting firms that will be required to register with the Board immediately after the applicable date in order to continue to participate in the audits of issuers after such date. For U.S. public accounting firms the applicable date is October 22, 2003. Because of the approaching registration deadline, and because the Board's Interim Auditing Standards, as approved by the SEC, currently require these public accounting firms to comply with them, the Board has deleted the note as unnecessary.

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accounting firms and their associated persons must comply with the Board's Standards in auditing non-issuers. Rule 3100, however, requires registered public accounting firms and their associated persons to comply with all *applicable* Standards. Accordingly, if the Board's Standards do not apply to an engagement or other activity of the firm, Rule 3100, by its own terms, does not apply to that engagement or activity.<sup>2/</sup>

Finally, one commenter suggested that Rule 3100 also require registered public accounting firms and their associated person to be duly licensed, registered or permitted or otherwise to hold valid practice privileges and be in good standing under

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<sup>2/</sup> For example, the Board's Interim Auditing Standards provide that, "[i]n connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002))." See Rule 3200T. The term "audit report" is defined in the Act and the Board's Rules to mean the audit of an issuer. See Rule 1001(a)(vi), adopted by the Board in PCAOB Release. No. 2003-007. Moreover, the Board notes that it would not be a correct description of its authority to say, as one commenter suggested Rule 3100 provide, that "A registered public accounting firm and its associated persons shall comply with all applicable professional auditing standards *in performing an audit of an issuer.*" Particularly with respect to the quality control standards the Board is authorized to establish, the Board may adopt standards that, while related to registered public accounting firms' audit practices, must be complied with other than in the course of performing an audit. Cf. Section 103(a)(2)(B) of the Act (requiring the Board to include, among the "quality control standards that it adopts with respect to the issuance of audit reports, requirements... relating to... hiring, professional development, and advancement of personnel").

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the laws of each applicable state. Registration with the Board does not supersede state registration or licensing requirements and the Board expects registered public accounting firms and their associated persons to comply with state and other applicable legal requirements. Rule 3100, however, is merely intended to codify the obligation of registered public accounting firms and their associated persons to comply with Board Standards and to ensure that the Board's Standards are enforceable. Accordingly, the Board has decided not to amend the Rule as proposed to reflect this suggestion.

## **Rules Relating to Advisory Groups**

### **Rule 3700 – Advisory Groups.**

Rule 3700 addresses certain basic matters concerning the formation and use of advisory groups in the Board's standards-setting process.<sup>3/</sup> The Rule provides that the Board will convene one or more advisory groups, as contemplated in Section 103(a)(4) of the Act. Any advisory group will consist of individuals with expertise in certain, specified areas relevant to the Board's standards-setting responsibilities. Members of an advisory group will be selected by the Board. In addition, the Rule provides for the

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<sup>3/</sup> The Rule does not address the use of an advisory group for matters other than standards-setting.

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Board to establish ad hoc task forces.<sup>4/</sup> While such task forces may include advisory group members, a task force may consist totally or partially of non-advisory group members who are persons with specialized experience in the standard-setting project under study. To the extent persons who serve on such task forces are not advisory group members or professional staff of the Board, they must comply with the ethics provisions applicable to advisory group members under Rule 3700(e).

The Rule further provides that membership on an advisory group will be personal to the individuals selected and that the functions of an advisory group member, including attendance at meetings, may not be delegated to others. This provision is based on a comparable provision in the Financial Accounting Standards Board's Rules governing the members of the Financial Accounting Standards Advisory Council.

Finally, Rule 3700 provides that members of a Board advisory group must comply with certain provisions in the Board's Ethics Code. Specifically, the Rule makes advisory group members subject to EC3, EC8(a) and EC9, and, to the extent applicable, EC10. These provisions of the Board's Ethics Code address, respectively,

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<sup>4/</sup> Such task forces may be formed without regard to the procedures for the formation, composition, and selection of advisory group members under Rule 3700(a)-(c).

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general ethical principles applicable to service for the Board, disqualification in the case of conflicts of interest, the non-disclosure of non-public information, and speaking for the Board when not authorized to do so by the Board.<sup>5/</sup>

Commenters suggested that it might be appropriate to establish more than one advisory group since expertise is likely to be required in more than one specialized area. The Board is aware that it may need advice in one or more specialized area. However, the Board has determined to form only one standing advisory group (the "SAG"). This group, however, may, at the Board's direction, form specialized sub-groups as needed. In addition, the Board may form ad hoc task forces to work with Board staff in formulating Standards in specialized areas which may then, in the Board's discretion, be added to the SAG's agenda for discussion at SAG meetings.

In addition, Commenters recommended adding other specific groups from which nominations could be received to the groups identified in Rule 3700(c) as proposed. After careful consideration of these comments, the Board has determined that Rule 3700(c) should reflect the Board's intention to accept nominations from all sources. Accordingly, Rule 3700(c) has been revised to state that the Board will accept

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<sup>5/</sup> See PCAOB Release No. 2003-008 (June 30, 2003) for the text of the Ethics Code adopted by the Board.

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nominations from any person or organization, including self-nominations. A note to this part of Rule 3700 provides that the Board will announce, from time to time, periods during which it will receive nominations for an advisory group.

With respect to qualifications of the advisory group members, one commenter suggested that all members have qualifications similar to those "requirements set forth for audit committee members in recently issued stock exchange and SEC" rules or proposed rules. The New York Stock Exchange ("NYSE") proposed listing requirements require that all members of audit committees of listed companies be financially literate. In addition, at least one member of the audit committee must meet the definition of an "audit committee financial expert."<sup>6/</sup> The NASDAQ Stock Market ("NASDAQ") proposed rules regarding qualifications for service on audit committees require that all audit committee members must be able to read and understand financial statements including a company's balance sheet, income statement, and cash flow statement and that the audit committee have at least one member who meets the

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<sup>6/</sup> See SEC Release No. 34-47672; File No. SR-NYSE-2002-33 (April 11, 2003).

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definition of an "audit committee financial expert."<sup>71</sup> After considering this comment, the Board has decided to adopt the Rule as proposed by the Board. While Rule 3700 does not specifically state the qualifications each member must have, the Rule does set forth the types of expertise that the Board will look for in advisory group members. In addition, as noted in Section C.4. of this Release, the Board may also consider certain specific qualifications in selecting nominees to the SAG. The Board believes that it will likely select members who, at a minimum, would meet the general qualifications set forth for "all" audit committee members in the proposed Rules of the NYSE and NASDAQ while providing the Board with the flexibility to select members from a broad spectrum of backgrounds to assist it in meeting the requirements of the Act. SAG members will be selected based upon qualifications which will be elicited from them on a nomination form and through the evaluative process.

Furthermore, commenters suggested that the composition of the SAG be flexible because the Board may find that it is unable to attract a sufficient number of qualified members from fields such as finance and investment. In response to this concern, it should be noted that, the Board expects that the SAG will be broadly representative and

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<sup>71</sup> See SEC Release No. 34-47516; File No. SR-NASD-2002-141 (March 17, 2003).

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that no one field of expertise will predominate among the SAG membership. Other concerns regarding composition related to assuring that the SAG have a sufficient number of members with technical expertise including requiring a majority of members to be practicing auditors. Although the Board certainly intends that the SAG have practicing auditors among its members, the Board believes that it is important that the SAG be able to provide advice in a broad range of areas, including technical auditing expertise, and that technical expertise in particular areas may be obtained by forming ad hoc task forces, as needed and as appropriate for particular standards-setting projects. Other commenters recommended that –

- (a) the four largest auditing firms be represented on the SAG;
- (b) non-U.S. auditors be represented;
- (c) the number of members associated with a single firm, company or association be limited;
- (d) membership be dispersed among those affiliated with firms, companies and associations of various sizes; and

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(e) there be a balance between financial information suppliers (representatives of public companies and auditors) and financial information users (equity and debt investors).

As noted above, the Board recognizes the need to have diversity on the SAG and in selecting members will keep diversity in mind while assuring that no one expertise will predominate among the SAG membership.

With respect to the actual functions of the SAG, one commenter, suggested that the SAG be involved in all standards-setting proposals while another commenter recommended that the actual drafting of the Standards fall within the SAG's authority. In order to maintain flexibility in the rulemaking process, the Board has determined not to revise the proposed Rule to reflect these comments. Although the SAG is likely to be involved in the Board's standards-setting process as discussed in the Release, the Board does not intend to make SAG involvement mandatory to every standards-setting project. In addition, the actual drafting of the Standards is likely to be done by the Board's staff assisted by ad hoc task forces where necessary.

Another comment related to recommending that the SAG work toward "harmonizing" international standards. Neither Rule 3100 nor 3700 is intended to

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address substantive standards-setting issues. Rather the Board intends to address such issues, including cooperation with standards-setters in other jurisdictions, in the future.

Commenters also made recommendations regarding SAG procedural matters. These commenters suggested that the Board address –

- (a) the process for making recommendations on Standards for consideration by the Board;
- (b) whether or not SAG meetings would be open to the public;
- (c) the format and the frequency of the meetings;
- (d) the process by which the Board will set the SAG's agenda;
- (e) the appointment of a Chair for the SAG;
- (f) whether the Board will provide all resources for drafting, editing, monitoring comments and publishing new and amended Standards;
- (g) the term of appointment to the SAG; and
- (h) an avenue for minority viewpoints to be expressed in any report or recommendation to the Board.

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With the exception of the comment on resources for drafting and publishing new Standards, the Board has addressed all of these comments in Section B.7. of the Release. In summary, the SAG will hold an annual meeting and a semi-annual meeting. Additional meetings may be held in the intervening quarters. Monthly telephonic meetings are also expected to be held at the discretion of the Chair. The annual and semi-annual meetings, and any meeting at which the SAG makes a final decision on a recommendation to the Board, will be open to the public. Agenda items for the SAG will be driven in part by the schedule to be set by the Board for the review of the Interim Auditing Standards. Other agenda items will be added by the Board where the Board determines that a response to emerging issues or problems connected with audits needs to be addressed. The Board has determined that the first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards. All SAG members will be appointed for two-year terms except that approximately one-half of the appointees initially appointed to the SAG will be appointed for a three-year term to assure continuity. There will be no limits on the terms that a member of the SAG may serve. The Board anticipates that drafting, editing, monitoring comments and publishing, will be conducted by the Board and its staff. To the extent that the SAG is

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specifically authorized by the Board to undertake any of these functions and the expenses have been preapproved by the Board or a staff member delegated by the Board, the Board will cover the SAG's costs.

In response to the issue of whether the SAG's meetings will be open to the public and in order to assure that the public is informed of the SAG's operations, the Board has determined that the annual and semi-annual meetings of the SAG will be open. In addition, decisions on making recommendations to the Board will only be made at an open meeting of the SAG. All recommendations to the Board by the SAG will be presented to the Board in open public meetings of the Board and such presentations will include the presentation of minority views of the SAG members. Finally, it should be noted that Board standards-setting proposals will be subject to the public comment process before being adopted by the Board.

With respect to Rule 3700(e) relating to the ethical duties of the SAG members, one commenter recommended that the SAG members be subject to Section EC14, the certification requirements, of the Ethics Code. In response to this comment, the Board has added to its "conditions of membership" described in Section C of the Release, a requirement that members of the SAG shall annually certify their continuing compliance

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with the "conditions of membership." A second commenter recommended that both Rule 3700(e) and EC8(a) of the Ethics Code be clarified to confirm that being a practicing auditor does not, in and of itself, constitute a financial interest requiring recusal. Section EC8(a) of the Ethics Code has been revised to add an explanatory note that clarifies this issue.<sup>8/</sup> A third commenter recommended that members of the SAG be prohibited from "unauthorized" speaking for the Board. In response to this comment, the Board has revised Rule 3700(e) to make EC10 of the Board's Ethics Code applicable to any private publication or public statement by an advisory group member with regard to the Board or the advisory group or any of the activities of the Board or the advisory group. Finally, a fourth commenter recommended that a member of the SAG be permitted to share SAG material with support personnel within the member's home organization who are assigned to assist the member in his or her duties. The Board has not added a provision to address this concern. The Board believes that SAG members will normally be able to perform their responsibilities without needing access to non-public Board information. To the extent that it may be appropriate, from time to time, to permit non-public standards-setting information to be

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<sup>8/</sup> See PCAOB Release No. 2003-008 (June 30, 2003).



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shared with individuals outside the SAG, including to permit SAG members to consult technical experts who are not employees or staff of the Board, the Board may require that such individuals agree to the confidentiality provisions under Section EC9 of the Ethics Code.