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August 19, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 006

Proposed Rules on Inspections of Registered Public Accounting Firms

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Rules on Inspections of Registered Public Accounting Firms*, PCAOB Rulemaking Docket Matter No. 006 (July 28, 2003).

INTRODUCTION

We support the goals of the Sarbanes-Oxley Act of 2002 (the "Act") in restoring investor confidence as well as the Board's efforts to implement the Act faithfully. The Act requires that the Board perform annual inspections of registered public accounting firms that regularly provide audit reports for more than 100 issuers, and triennial inspections of firms that regularly provide audit reports for 100 or fewer issuers. These inspections are designed for the Board to assess firms' compliance with the Act, the rules of the Board and the Securities and Exchange Commission ("SEC"), the firms' own quality control policies, and professional standards in

connection with the performance of audits, the issuance of audit reports and related matters involving issuers.[1]

In this comment letter, we have identified aspects of the Board's proposed rules that we believe should be clarified or modified in order both to facilitate the conduct of inspections and to enhance the ability of registered public accounting firms to understand and to respond appropriately to the requirements associated with inspections. We begin with a few general comments, which are followed by specific comments that track the order of the rules proposed in the Board's Release No. 2003-013, dated July 28, 2003 (the "Release").

I. General

We have several general concerns that we believe the Board should consider as it finalizes the proposed rules.

First, the Board's proposed rules contain little in the way of substantive guidance on the inspection process. The Release state that the Board's proposed rules on inspections "govern procedural matters concerning the Board's inspection program," but that Board staff will carry out particular inspections according to "detailed, nonpublic inspection plans."[2] The Board should provide guidance to registered public accounting firms about the conduct of inspections so that firms are better prepared to participate in the inspection process and are aware of and have appropriate insight about the substantive criteria by which they are being evaluated. It seems only reasonable that firms should have a clear understanding of the inspection process and the evaluative criteria to be used.

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[1] *See* Act, §§ 104(a) and 104(c)(1).

[2] Release at 2, n.2.

Second, as discussed in connection with a number of the specific comments set forth below, we believe that certain provisions of the Board's proposed rules are overly broad and unnecessarily vague. The proposed rules do not provide sufficient clarity and specificity regarding the duties, rights and responsibilities of the various parties involved in the inspection process. Nor do they provide the Board's staff or firms with sufficient direction and information regarding the overall inspection process, the conduct of inspections, or the form of the resulting inspection reports. In the remainder of this letter, we provide additional comments regarding particular areas of the proposed rules that require greater clarity and specificity. In the absence of clarification and additional detail, unfairness, inefficiencies and needless confusion could result, thereby compromising the effectiveness of the inspection process.

Third, the Release states that the proposed rules apply to inspections of registered public accounting firms.[3] The Board states in the Release that non-U.S. public accounting firms are not required to register with the Board until April 19, 2004, at which time they may become subject to the inspection rules.[4] The Board should clarify that, other than U.S. registered public accounting firms, non U.S. "associated persons" of either U.S. registered public accounting firms or non-U.S. public accounting firms that register on or before April 19, 2004 also will not be subject to the inspection rules until, at the earliest, April 19, 2004.

Finally, the proposed rules should explicitly state that the scope of the Board's inspections will not extend to non-issuer clients or to services that registered public accounting firms provide to non-issuers. This would be consistent with Section 104(a) of the Act, which

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[3] *Id.* at 9.

[4] *Id*. The Board also states in the Release that its proposed rules "are not intended in any way to signal that the Board has already determined how its oversight should operate as to [non-U.S.] firms, or to preclude any adjustments that may be appropriate" in light of the Board's discussions with its foreign counterparts. *Id*. at 9-10.

limits the Board's inspection authority to firms' "performance of audits, issuance of audit reports, *and related matters involving issuers*" (emphasis added). Although proposed Rule 4001 contains similar language, this rule governs only regular inspections. Accordingly, we believe a broader statement that the Board's inspection process does not cover firm activities pertaining to non-issuer clients would be appropriate.

II. DEFINITIONS—"PROFESSIONAL STANDARDS"

As an initial matter, the Board should either clarify that the use of the term "professional standards," as defined in proposed Rule 1001(p)(iv), is not intended to expand the scope of conduct for which accounting firms may be subject to investigation or discipline, or instead use the term "auditing and related professional practice standards" when referring to the responsibilities of auditors. Unlike the term "auditing and related professional practice standards," which is defined in Rule 1001(a)(viii) of the Rules of the Board to include auditing standards, related attestation standards, quality control standards, ethical standards, independence standards, and other professional standards established or adopted by the Board under Section 103 of the Act, the term "professional standards," as used in Section 2(a)(10) of the Act and proposed Rule 1001(p)(iv), will encompass accounting principles as well. The Board acknowledges in the "Section-by-Section Analysis" of the Release that "professional standards" are broader than "auditing and related professional practice standards," but this should not be understood to extend the Board's inspection, investigation, and disciplinary authority beyond the Board's mission to oversee the integrity of public company audits.[5]

The inclusion of accounting principles in the term "professional standards" is important because under proposed Rule 4004, the Board has authority to refer firms to the SEC and

[5] *Id*. at A2-i.

relevant licensing and certification authorities, and to commence investigations or disciplinary proceedings, in connection with any act, practice or omission by a firm, any associated person of a firm, or any other person that may be in violation of any "professional standards." As proposed, it appears that the definition of "professional standards" could be read to expand the auditor's responsibility and subject accounting firms to discipline for departures by issuers of generally accepted accounting principles even when a firm has acted with due professional care.

We are concerned that any such expansion is inconsistent with an auditor's responsibility under generally accepted auditing standards. Primary responsibility for the application of accounting principles rests with management of an issuer. Auditors have a responsibility to perform an audit under generally accepted auditing standards and to report on the financial statements based upon the audit. The resulting audit report contains an opinion as to whether the financial statements are presented fairly and in conformity with generally accepted accounting principles with regard to all material matters. This opinion has always been understood to provide reasonable, but not absolute, assurance regarding the financial statements.[6]

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[6] *See* AU 110.02 – 110.03 (Responsibilities and Functions of the Independent Auditor), which states that:

> The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.
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> The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's knowledge of

Auditors should be responsible, as they traditionally have been, for conducting audits of issuers' financial statements in accordance with generally accepted *auditing* standards. The Board's proposed rule should not fundamentally expand the role and responsibility of the auditor. Accordingly, if the Board determines that there has been a misapplication of generally accepted accounting principles, before it concludes that an auditor has not met its responsibilities, there should be further consideration of whether, and a determination that, there has been a violation of auditing and professional practice standards before a matter is referred or a disciplinary proceeding is commenced.

III. PROPOSED RULE 4000 "OTHER PERSONS" AUTHORIZED TO PARTICIPATE IN INSPECTIONS

Proposed Rule 4000 states that "[i]nspection steps and procedures shall be performed by the staff of the Division of Registration and Inspections, and by *such other persons as the Board may authorize to participate in particular inspections or categories of inspections*" (emphasis added). The Board should provide specific guidance regarding who are the "other persons" who can be authorized to participate in inspections and should set out the circumstances under which their participation can be authorized. The proposed rule does not appear, for example, even to require that these "other persons" be members of the Board's staff.

In this regard, because they will have access to information that may be highly confidential, the Board should limit the instances in which persons other than Board staff can be authorized to participate in inspections. In addition, the "other persons" should be required to

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these matters and internal control is limited to that acquired through the audit. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. The independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management during the performance of the audit. However, the auditor's responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on them.

satisfy some uniform criteria reasonably designed to ensure that they have appropriate professional qualifications and are free from conflicts of interest. To the extent that such "other persons" are called upon to exercise certain powers of the Board, additional restrictions may be appropriate or necessary. "Other persons" that participate in inspections should also be required to sign confidentiality agreements stipulating that they are bound by the same confidentiality obligations as are the Board and its staff.

IV. PROPOSED RULE 4001 REGULAR INSPECTIONS

Proposed Rule 4001 provides that the procedures that the Board performs in connection with regular inspections must include an inspection and review of "selected audit and review engagements" of firms, as set forth in Section 104(d)(1) of the Act. For purposes of clarification, the Board should revise proposed Rule 4001 to provide that "selected audit and review engagements" do not include engagements that are ongoing at the time an inspection is conducted. We believe that it would be inappropriate for the Board to examine engagements that are in process as part of an inspection because the examination necessarily would result in a distorted picture of these engagements and would otherwise be unduly disruptive to the completion of the audit.

V. PROPOSED RULE 4002 SPECIAL INSPECTIONS

Proposed Rule 4002 should provide greater specificity about the circumstances for the initiation of special inspections. Special inspections are those inspections conducted other than once each calendar year, or once every three calendar years, depending on the firm.[7]

First, the Board should clarify under what circumstances and by what procedures a special inspection will be initiated. The note to proposed Rule 4002 states that special

[7] *See* Proposed Rules 4003(a) and 4003(b).

inspections can be initiated “on [the Board’s] own initiative” or at the request of the SEC. This language could be interpreted to necessitate, and appropriately so, formal Board action, which, under Section 4.3 of the Board’s Bylaws, requires a quorum and approval of a majority of the Board’s members. Alternatively, it could be read to permit initiation of special inspections whenever some of the Board’s members deem it necessary or appropriate, or upon approval of Board staff alone. Proposed Rule 4002 is silent as to when the SEC may request special inspections.

To ensure that special inspections are initiated only when circumstances warrant, formal Board action – that is, a quorum and approval of a majority of the Board’s members – should be required in order to initiate a special inspection, including in instances where the SEC requests that the Board undertake a special inspection. Moreover, to remove any implication to the contrary, we believe that proposed Rule 4002 should be amended to clarify that the Board has the same authority in the context of a special inspection that it has in conducting regular inspections.

Second, proposed Rule 4002 does not explicitly provide for notification to a firm at the time a special inspection is initiated, which leaves open the possibility that the Board could undertake “surprise” inspections by sending staff to a firm’s offices without prior notice, to review records or interview firm personnel. This creates an ambiguity when viewed in light of proposed Rule 4006, which requires firms and their associated persons to cooperate in inspections and clearly contemplates that firms will receive sufficient notification of an inspection to provide documentation and other information relevant to the inspection. We believe that the Board should notify firms of a special inspection immediately upon authorization of the inspection (and sufficiently in advance of its initiation) and that proposed Rule 4002 should be revised to provide for such notification.

Third, the Release states that an inspection can be commenced "based on information that comes to the attention of the Board or its staff in any way," including through SEC filings, news reports and "matters brought informally to the attention of the Board's staff by other regulators, professional associations, informants, and members of the public."[8] Neither the Release nor the proposed rule establishes a specific standard that would trigger special inspections. Presumably, mere rumors of a violation would not be sufficient grounds for the Board to commence a special inspection. In this regard, we believe it would be appropriate to establish a minimum threshold that must be satisfied before the Board can commence a special inspection, such as a reasonable belief on the part of a majority of the Board that a violation of the Act, the rules of the Board, any statute or rule administered by the SEC, the firm's own quality control policies, or any professional standard, may have occurred. Incorporating this standard into proposed Rule 4002 would leave the Board free to initiate inspections as special circumstances warrant.

VI. PROPOSED RULE 4004 PROCEDURE REGARDING POSSIBLE VIOLATIONS

Proposed Rule 4004 grants the Board sweeping authority to refer information to the SEC and relevant licensing and certification authorities, including authority to make additional referrals other than those specifically described in the rule. The Board should establish parameters governing when, and to whom, it may make additional referrals and these parameters should be reflected in proposed Rule 4004.

The Act and proposed Rule 4004 provide for referrals to the SEC and relevant licensing and certification authorities "if appropriate."[9] Similarly, the Board has discretion under the note to proposed Rule 4004 to make other referrals "as appropriate." This is a substantial grant of

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[8] Release at 7.

[9] *See* Act, § 104(c)(2); proposed Rule 4004(a) (the Board "shall" make a referral "if it determines appropriate").

discretion to the Board, particularly because the language of proposed Rule 4004 allows the Board to refer firms to the SEC and relevant licensing and certification authorities upon any "indication" that there "may be" or "may have been" a violation. If, however, the Board were to make a referral every time there is a suggestion of a potential violation, the referral system would be administratively unworkable for both the Board and other authorities that oversee registered public accounting firms. The Board would be forced to expend significant resources preparing referrals based on the scantest of evidence, and recipients of referrals would face the prospect of substantial additional follow-up to assess the merits of alleged violations referred by the Board. Meanwhile, the Board would continue to perform its own assessments of potential violations to determine whether to commence investigations and disciplinary proceedings, resulting in a substantial duplication of effort by the Board, the SEC, and state licensing and certification authorities.

Moreover, referring firms to the SEC and relevant licensing and certification authorities on the basis of mere indications of suspected potential violations could cause unwarranted damage to a firm's professional stature and would not be in the interest of the public or consistent with the Board's mission. Unfounded allegations of wrongdoing by a firm that may become public would unnecessarily undermine investor confidence in the integrity of the financial reporting process, and responding to such allegations would divert firms' resources from the performance of audits.

Accordingly, we believe that the Board should exercise the discretion afforded to it by the language of the Act to establish standards for determining the propriety of referrals. For example, as proposed, Rule 4004 would permit the Board to make referrals in cases where there may be a violation of generally accepted accounting principles. As discussed above, we believe a further determination regarding a deviation from generally accepted auditing standards should

be required prior to referring a matter to the SEC or relevant licensing and certification authorities or initiating a disciplinary proceeding. The need for such a limitation is particularly compelling because, as the proposed rule is currently drafted, even a single omission of a minor disclosure required under generally accepted accounting principles, that in the overall picture is not material to the financial statements and that may not bear any relationship to the firm's conduct of an audit under generally accepted auditing standards, or a departure from such standards, could trigger a referral or a disciplinary proceeding.

VII. PROPOSED RULE 4006 DUTY TO COOPERATE WITH INSPECTORS

As proposed, Rule 4006 would require that all registered public accounting firms and their associated persons cooperate with the Board in the performance of "any" Board inspection. Proposed Rule 4006 would require firms to provide the Board with access to, and the ability to copy, "any record" in their possession, and to give the Board access to "such other information as may be requested by the Board's inspectors and that the Board considers relevant or material to the subject matter of the inspection."

The vast expanse of information to which the Board would have access under proposed Rule 4006 raises serious concerns. As drafted, proposed Rule 4006 seemingly requires firms to provide the Board with access to and the ability to copy "any" record in their possession, even if the record has no relevance to an inspection. As an initial matter, therefore, the language of the proposed rule must be revised to confirm that the proposed rule's proviso regarding "relevan[ce] or material[ity] to the subject matter of the inspection" applies to records.

Even if records are relevant to an inspection, moreover, the Board should not have an unfettered ability to copy those records. Client confidentiality dictates that the duplication of records should be limited in order to avoid inadvertent disclosure of confidential information. Accordingly, before Board staff is permitted to duplicate and remove copies of records from the

offices of registered public accounting firms, we believe that the staff should be required to demonstrate a reasonable need for copies of the records that could not be met through mere access to those records.

Another difficulty raised by the expansive language of proposed Rule 4006 is that it contains no safeguards to ensure that firms or their associated persons can assert any common-law or constitutional privileges, such as the attorney-client privilege or the work product doctrine, once confronted with an actual request from the Board under the rule. Accordingly, the Board should confirm that firms and individuals may assert legally recognized protections in objecting to particular requests for documents, interviews and other information, and that the Board will not view the assertion of privileges as a failure to cooperate with the Board in the performance of an inspection.

In addition, providing client confidential information to a third party, including the Board, presents numerous potential conflicts with state laws and with non-U.S. laws and professional standards.[10] Therefore, we are concerned that proposed Rule 4006 would place firms and their associated persons in the untenable position of either refusing to comply with – and thereby possibly violating – the Board's rule on cooperating with inspectors, or providing client information to the Board, and thereby committing an act that may violate state law or non-U.S. laws or professional standards.

To avoid the harsh consequences to which proposed Rule 4006 could lead, we recommend that the Board amend the proposed rule to provide that the production of documents

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[10] *See* App. A to Comment Letter, dated March 31, 2003, on behalf of Deloitte & Touche LLP, the Non-U.S. Member Firms of Deloitte Touche Tohmatsu, and Deloitte Touche Tohmatsu on the PCAOB's Proposed Registration System for Public Accounting Firms, PCAOB Rulemaking Docket Matter No. 001 (outlining potential conflicts between the consent provision in Item 8.1 of the Board's proposed registration rules and confidentiality requirements in the laws and professional standards of certain foreign countries).

and other information covered by the rule is required only to the extent consistent with applicable laws and professional standards and to include an express reservation that firms and their associated persons would maintain their rights to assert any legally recognized grounds for objecting to a request for documents, interviews or other information. Specifically, the rule should provide that before firms or their associated persons are required to turn over information to the Board, they will have an opportunity to be heard with respect to any legal grounds they may have for not producing information to the Board.

VIII. PROPOSED RULE 4007 PROCEDURES FOR FIRM REVIEW OF AND RESPONSE TO DRAFT INSPECTION REPORT AND ISSUANCE OF FINAL INSPECTION REPORT

We have identified several changes to proposed Rule 4007 that we believe are integral to the fairness and accuracy of the inspection reporting process. As a general matter, the proposed rule does not outline any parameters regarding the preparation of inspection reports, including matters such as the content and format of reports and thresholds related to findings discussed in reports. The provisions of proposed Rule 4007(b) that address confidentiality are not sufficiently specific and require further clarification. In addition, the procedures set forth in proposed Rule 4007(c) do not afford firms an adequate opportunity to review draft inspection reports. Finally, we believe that proposed Rule 4007 should permit firms to comment on final inspection reports.

A. PROVISIONS PROTECTING CONFIDENTIALITY MUST BE CLARIFIED

As an initial matter, the Board states in the "Section-by-Section Analysis" of the Release that it would automatically keep confidential, without the need for a specific request by a firm, any portions of a firm's response to a draft inspection report that address criticisms of and potential defects in the firm's quality controls.[11] However, the "Section-by-Section" analysis seemingly conflicts with the note to proposed Rule 4007(b), which states that the Board will

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[11] Release at A2-vii.

protect information in a firm's response to a draft inspection report from disclosure "only if it is reasonable to characterize the information as confidential." The confidentiality that the Board intends to afford to portions of a firm's response that address criticisms of and potential defects in its quality controls should be explicitly set forth in the text of Rule 4007.

Moreover, the Board offers no guidance in the proposed rule or the accompanying note as to when it would be "reasonable" to consider information confidential. The process of reviewing and responding to draft inspection reports can be meaningful only if firms have the freedom to be candid in their responses. In situations where responding accurately and completely to a draft inspection report would necessitate the disclosure of confidential information, a firm may be reluctant to respond—and potential errors or inaccuracies in the Board's report could go uncorrected—if a firm does not know what will be treated as confidential. To promote candor in the review process, the Board should provide firms with clear guidelines or examples as to when information (outside the quality control context, in which the Board has indicated that confidential treatment would be automatic) may reasonably be considered confidential.

In addition, the Board should confirm that firms are not required to provide supporting documentation to justify a request for confidential treatment. Based on the note to proposed Rule 4007(b), which states that a firm "may" supply such information, it is our understanding that supporting documentation is not required.

B. THE BOARD SHOULD STRENGTHEN ITS PROCEDURES FOR FIRM REVIEW AND COMMENT ON DRAFT INSPECTION REPORTS

We believe that proposed Rule 4007(c) does not afford firms adequate opportunity to review and to respond to draft inspection reports. Section 104(f) of the Act requires the Board's rules to provide a procedure for the review of and response to any draft inspection report. Proposed Rule 4007(c), however, provides that the Board "may, in its discretion, afford the firm the opportunity to review any revised draft inspection report." Allowing the Board discretion in

this regard does not comport with the clear mandate in Section 104(f) of the Act. Accordingly, proposed Rule 4007(c) should be revised to provide that firms must be given the opportunity to review and provide comments on all draft inspection reports (whether initial or revised).

Proposed Rule 4007(c) also goes beyond the Act by permitting the Board to "adopt[] [a] draft report as the final report" after receiving and reviewing any response letter submitted by a firm under proposed Rule 4007(b). Finalizing inspection reports under these circumstances, without any further communication between the Board and the firm that is the subject of the report, would result in a situation where a firm is left to wonder about the Board's views on its response letter and whether and how the firm's response will be reflected in the final inspection report. To prevent this result, the Board must provide the opportunity for a hearing or other review process prior to finalization of the report. This would allow a firm that has submitted a written response to a draft inspection report to participate in an interactive dialogue with the Board about any concerns articulated in the written response and to ensure that it has had an opportunity to respond fully to any issues identified in the draft report before the Board finalizes the report.

C. FIRMS SHOULD HAVE A RIGHT TO COMMENT ON THE FINAL INSPECTION REPORT

Once the Board has prepared a final inspection report, we believe that firms should be able to submit comments on the final report. In the event that a firm disagrees with any of the conclusions in the report, or believes that further clarification is appropriate, the firm should have an opportunity to document its views in writing and those views should accompany any public disclosure or referral of the report. For example, a disagreement between the Board and a firm over the adequacy of particular aspects of the firm's quality control systems might be viewed differently by the relevant state accounting authority if the authority had access to the views of both the Board and the firm.

IX. PROPOSED RULE 4008 TRANSMITTAL OF FINAL INSPECTION REPORT

Proposed Rule 4008 mandates that the Board transmit copies of final inspection reports to the SEC and (in appropriate detail) relevant licensing and certification authorities,[12] and permits, but does not require, the Board to include in the transmittal "any additional letter or comments by the Board or the Board's inspector that the Board deems appropriate." If, as we suggested in our comments on proposed Rule 4007, the Board determines that firms should have the opportunity to comment on final inspection reports, we believe that the full text of any firm comments should be transmitted along with any final report.

In addition, proposed Rule 4008 should explicitly confirm that the transmission of final inspection reports is subject to the confidentiality provisions in Section 105(b)(5)(B) of the Act. Moreover, although we understand that making final inspection reports available to the SEC and other agencies, as well as to the public, is contemplated by the Act,[13] we are concerned that, unless clarified, such availability may be administered in a manner inconsistent with the Act's provisions protecting the confidentiality of this information. We suggest the following revisions in order to ensure that final inspection reports remain confidential and privileged, even when provided to the agencies listed in the Act, to the extent information contained in the reports is not otherwise disclosed to the public. We believe that these revisions are strongly supported by the

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[12] Proposed Rule 4008(c) specifies those authorities other than the SEC to which the Board must transmit copies of final inspection reports, in appropriate detail, and includes "each state, agency, board, or other authority that has issued a license or certification number authorizing the firm to engage in the business of auditing or accounting."

[13] *See* Act, § 104(g).

Act, which states that "each of [the agencies receiving final inspection reports] shall maintain such information as privileged and confidential."[14]

First, the Board should release final inspection reports to another agency only under a confidentiality agreement. Section 105(b)(5)(A) of the Act states that inspection-related documentation and information shared with an agency "shall be confidential and privileged *as an evidentiary matter* (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency." Although this provision may prevent state or federal agencies from introducing final inspection reports *as evidence in judicial or administrative proceedings*, proposed Rule 4008 does not explicitly prevent such an agency from disclosing the report to the public on its own initiative. If the Board were to require agencies to enter into confidentiality agreements as a condition of receiving final inspection reports, that agreement would bar agencies from releasing the reports to the public, and would thereby carry out Congress's mandate that agencies keep this information confidential. Alternatively, the Board could specify explicitly in its rule that a receiving agency is prohibited from disclosing final inspection reports to anyone outside the receiving agency and could require the Board's staff to advise the recipient agency of these obligations.

Second, the final rule should explicitly confirm that state law is preempted to the extent that state law would otherwise require a state agency in receipt of a final inspection report to disclose it. Section 105(b)(5)(A) of the Act states that documents and information prepared or received by or specifically for the Board in connection with an inspection "shall be exempt from disclosure, in the hands of an agency or establishment of the Federal Government, under the Freedom of Information Act (5 U.S.C. 552a), or otherwise." This language, however, does not

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[14] *Id*. § 105(b)(5)(B)(ii)(IV).

directly cover the status of the information in the hands of state attorneys general and other "appropriate State regulatory authorit[ies],"[15] including those authorities listed in proposed Rule 4008(c). Once the Board transmits a final inspection report to a state agency, the state agency might be required by various state "freedom of information acts" or similar state laws to disclose that information whether or not requested by the public.[16] Notwithstanding that final inspection reports are confidential under Section 105 of the Act, disclosure to a state agency may effectively subject such information to public discovery if the rule's language is not clarified. Accordingly, the final rule should expressly confirm that state law is preempted to the extent that it would otherwise permit or require the receiving state agency to disclose final inspection reports. Such a statement would faithfully implement the Act's requirement that receiving state agencies "maintain such information as confidential and privileged."

The Board also should ensure that its comments or letters submitted with the final inspection report are treated confidentially. In this regard, Proposed Rule 4008 should also be revised to confirm that additional letters or comments of the Board are not deemed to be part of any final inspection report. As a result, additional letters and comments would remain confidential in accordance with Section 105(b)(5)(A) because they constitute information prepared by the Board in connection with an inspection. If the Board should disagree and take the position that additional letters or comments are not confidential, the rule should provide that the firm has the same rights with respect to these communications that we believe the Board should provide for final inspection reports – that is, the right to respond in writing to the letters

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[15] *Id*.

[16] *See*, *e.g.*, Cal. Gov't Code § 6250 *et seq.*; Tex. Gov't Code § 552.001 *et seq.*; 5 Ill. Comp. Stat. 140/1, *et seq.*; N.Y. Pub. Off. Law § 84, *et seq.* Even if the agency decided not to disclose this information to the public, public interest groups and private litigants could still seek this information in the absence of preemption.

or comments, and to have its response accompany any public disclosure or referral of the letters or comments.

X. Proposed Rule 4009 Firm Response to Quality Control Defects

Proposed Rule 4009 outlines the procedure by which firms can provide evidence to the Board that criticisms of and potential defects in their quality control systems contained in a final inspection report have been improved and remedied, as appropriate. Because the failure to address criticisms and potential defects "to the satisfaction of the Board" will result in public disclosure of those criticisms and potential defects, we believe that certain modifications to the rule are necessary in order to ensure fair and accurate reporting to the public.

First, the Board should provide guidance as to the meaning of the phrase "criticisms of, or potential defects in, the quality control systems of the firm under inspection."[17] A lack of clarity regarding the scope of this phrase will result in inconsistencies in the inspection process and in determinations regarding the quality control issues that should be documented in inspection reports. Additionally, the Board should be able to distinguish between minor infractions and those that are significant.

Second, once a firm submits evidence that it has improved its quality control systems and remedied any potential defects, but before the Director of the Division of Registration makes its final recommendation to the Board, the Board should provide the opportunity for a hearing or other review process in instances where there is uncertainty about whether the firm has in fact made the appropriate improvements or remedied any potential defects. Where a firm makes a good faith effort to address criticisms of or potential defects in its quality control systems, fairness and equity dictate that the firm should have the opportunity to communicate with the

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[17] *See* Proposed Rule 4009.

Director about the sufficiency of its corrective measures, and any additional modifications the Director believes may be necessary, prior to the Board's final determination. If the firm becomes aware of additional relevant information after the Director makes a recommendation to the Board, the firm should also have the opportunity to present information to the Board at that time.

Third, the Board should not be able to publish criticisms of or potential defects in a firm's quality control systems when the firm has requested SEC review of a final Board determination that the firm has not addressed these criticisms or defects to the Board's satisfaction. As drafted, proposed Rule 4009(c)(3) would permit the Board to make quality control information public 15 days after a firm requests SEC review unless the SEC directs otherwise. To publish quality control information while the SEC's review is ongoing could cause irreparable harm to a firm, would be unfair and inequitable, and would not be in the public interest or consistent with the Board's mission. Section 104(h)(1) of the Act provides for the SEC to promulgate rules governing the SEC review process. Although the SEC has not yet proposed rules in this area, it is virtually certain that the review process will take more than 15 days, and the SEC may well conclude following a review that a firm has adequately addressed any criticisms or potential defects in its quality control systems. Accordingly, the SEC should be allowed adequate time to conduct its review, and information about any criticisms of or potential defects in a firm's quality control systems should be kept confidential pending completion of the review.[18]

Fourth, proposed Rule 4009 should be revised to incorporate the requirements of Section 104(g)(2) of the Act, which contains an absolute prohibition on disclosing portions of a final

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[18] The Board may believe that the 15-day provision gives the SEC adequate time to direct otherwise. In practice, however, hard-pressed professionals at the SEC will not be able to meet such short deadlines. Also, longer periods for consideration will lead to better and more finely calibrated regulatory outcomes.

report that deal with potential defects in quality controls systems if they are addressed to the Board's satisfaction no later than 12 months after the date of the inspection report. To avoid potential breaches of confidentiality, proposed Rule 4009 should expressly prohibit any recipient of a final inspection report under proposed Rule 4008, including the SEC and relevant licensing and certification authorities, as well as the firm that is the subject of the report, from disclosing sections of the report or of any additional letters or comments accompanying the report, that discuss criticisms of or potential defects in quality control systems, until disclosure is otherwise authorized under Rule 4009.

Fifth, the Board should confirm that the confidentiality afforded by proposed Rule 4009 extends not only to the portions of an inspection report that discuss criticisms of or potential defects in quality control systems, but also to any transmittal letter or other communication notifying a firm of a final determination by the Board, in accordance with proposed Rule 4009(b), that a firm has not addressed those criticisms and potential defects to the Board's satisfaction. If the Board disagrees that the transmittal letter is confidential, the rule should provide that the firm has the same rights with respect to the letter that we believe the Board should provide for final inspection reports – that is, the right to respond in writing to the transmittal letter and to have its response accompany any public disclosure or referral of the letter.

Sixth, as currently drafted, proposed Rule 4009(c) affirmatively provides that the portions of a final report dealing with quality control criticisms and potential defects will be made public upon the occurrence of certain events. We believe that the proposed rule should provide that the relevant portions of the report will not be made public until the last to occur of: (1) the expiration of the 12-month period after the issuance of a final inspection report (if a firm fails to respond to the report); (2) the expiration of the 30-day period during which a firm may seek SEC review of

a final Board determination that the firm has not responded to potential quality control defects or criticisms identified by the Board; or (3) the conclusion of the SEC review process.

Finally, prior to the Board's public disclosure of criticisms and potential defects relating to a firm's quality control systems, the firm should have the opportunity to respond to the proposed disclosure. The firm's response should be included in the disclosure when it is made public.

XI. PROPOSED RULE 4010 BOARD PUBLIC REPORTS

Proposed Rule 4010 does not accord appropriate weight to confidentiality concerns and should be modified in several respects to address these concerns.

Proposed Rule 4010 should be revised to incorporate by reference the restrictions on disclosure of confidential information mandated by Section 104(g)(2) of the Act, which governs public disclosure of final inspection reports. Section 104(g)(2) requires the Board to make final inspection reports available to the public in appropriate detail, subject to exclusions for confidential information, information prepared or received by or specifically for the Board (as set forth in Section 105(b)(5)(A) of the Act), and portions of reports that deal with criticisms of or potential defects in a firm's quality control systems. Although proposed Rule 4010 implements Section 104(g)(2), the proposed rule makes no mention of the statutory provision regarding confidentiality.

In addition, the Board should clarify whether, and to what extent, proposed Rule 4010 permits publication of information that the Board is restricted or prohibited from disclosing under proposed Rules 4007, 4008 and 4009. Proposed Rule 4010 permits the Board to publish reports about Board procedures, findings, and inspection results "[n]otwithstanding any provision of Rules 4007, 4008, and 4009." Accordingly, the proposed rule appears to permit the Board to disclose to the public: (1) information contained in draft inspection reports (proposed

Rule 4007); (2) information that firms include in their responses to draft inspection reports and that the Board has agreed to treat as confidential (proposed Rule 4007); (3) information contained in final inspection reports that the Board has the option of not transmitting to state licensing and certification authorities, if it could interfere with investigations, prosecutions, or disciplinary proceedings (proposed Rule 4008); and (4) certain information about criticisms of and potential defects in quality control systems (proposed Rule 4009). Moreover, the prohibition in proposed Rule 4010 on disclosure of firm-specific information covers only information pertaining to potential defects in and criticisms about quality controls.

We believe that public disclosure of certain information that is otherwise exempt from disclosure under proposed Rules 4007, 4008 and 4009 would be wholly inappropriate because it would be inconsistent with the requirements of the Act and other provisions of the proposed rules. Draft inspection reports, which are covered by proposed Rule 4007, are confidential under the plain language of Section 105(b)(5)(A) of the Act because they constitute "information prepared . . . by . . . the Board . . . in connection with an inspection." Moreover, we do not believe that the Board should have the authority under proposed Rule 4010 to disclose publicly information contained in a draft inspection report before a firm has had the opportunity to respond to the report in accordance with the procedures set forth in proposed Rule 4007(b). Similarly, allowing the Board to disclose under proposed Rule 4010 information in a firm response to a draft inspection report, when Section 104(f) of the Act requires that the text of the firm's response be "appropriately redacted to protect information reasonably identified . . . as confidential" and the Board has agreed to keep that information confidential, would eviscerate the protections afforded to firms under the confidentiality provision in proposed Rule 4007(b).

With regard to proposed Rule 4008, the Board should not have the authority to make public disclosure under proposed Rule 4010 of information that it determines not to share with

state licensing and certification authorities because of the risk that doing so would interfere with an investigation, prosecution or disciplinary proceeding. With regard to proposed Rule 4009, Section 104(g)(2) of the Act expressly states that "no portions" of an inspection report that deal with criticisms of or potential defects in a firm's quality control systems can be made public if they are addressed to the Board's satisfaction no later than 12 months after the date of the inspection report. In view of the clear statutory requirement, which is reflected in proposed Rule 4009(c)(1), we do not believe that the Board has the authority to make even generalized disclosures about criticisms of or potential defects in quality controls systems until this 12-month period has expired and a firm has failed to address the criticisms or potential defects and has exhausted any SEC review procedures that it intends to pursue. Moreover, we have concerns that permitting disclosure under proposed Rule 4010 of even general information about criticisms of and potential defects in the quality control systems of ostensibly unnamed firms could result in disclosure of a firm's identity. For these reasons, we believe that the Board's authority under proposed Rule 4010 to make public disclosure of procedures, findings and inspection results should be subject to, rather than exempt from, the confidentiality provisions in proposed Rules 4007, 4008 and 4009.

It would also be appropriate to keep confidential for a limited time period any information relating to audit engagements that are the subject of ongoing litigation or controversy between a firm and one or more third parties. Section 104(d)(1) of the Act and proposed Rule 4001 permit the Board to inspect and review such engagements as part of its broader inspection authorities. However, because of the possibility that even general disclosures could reveal a firm's identity or adversely impact a pending or possible legal proceeding, information about audit engagements that are the subject of ongoing litigation or controversy should remain confidential until the conclusion of the litigation or controversy.

Finally, if the Board disagrees with the points expressed in part IV of this letter and determines that its authority to conduct regular inspections under Section 104(d)(1) and proposed Rule 4001 covers ongoing engagements, we believe it would be appropriate to keep confidential information relating to any engagement that has not been completed at the time it is subject to inspection, until the engagement has concluded.

CONCLUSION

Due to the short time frame within which the Board has requested comments and the complicated nature of the proposed rules, it may be useful to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman
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