

PCAOB Release No. 2003-013
July 28, 2003
Page 2

submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 006 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on August 18, 2003.

Board

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Section 104(a) of the Act directs the Board to conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with the Act, the Board's and the Commission's rules, and professional standards in connection with the performance of audits, the issuance of audit reports, and related matters involving U.S. public companies.^{1/} Section 101(c)(3) of the Act provides that the Board shall "conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board." To implement this directive and to comply with Section 101(c)(3), the Board has proposed rules relating to inspections, which are summarized below in Section A of this release.^{2/}

^{1/} This release uses the term "U.S. public companies" as shorthand for the companies that are "issuers" under the Act and the Board's rules. This includes domestic public companies, whether listed on an exchange or not, and foreign private issuers that have either registered, or are in the process of registering, a class of securities with the Commission or are otherwise subject to Commission reporting requirements.

^{2/} The proposed rules govern procedural matters concerning the Board's inspection program. Board staff will carry out particular inspections according to detailed, nonpublic inspection plans.

The Board seeks the views of interested persons on the proposed inspection rules. Section B of this release describes how comments and views may be submitted to the Board. The Board's proposal consists of 10 rules (PCAOB Rules 4000 through 4010) plus a related definition. The text of these rules and a detailed discussion of each of the rules are attached as Appendices 1 and 2, respectively.

A. Overview of the Board's Inspections Rules

1. The Board's staff will conduct regular and special inspections of registered public accounting firms.

Consistent with Section 104(a) of the Act, the Board's proposed rules subject public accounting firms that are registered with the Board to regular and special inspections as the Board may from time-to-time conduct.^{3/} Section 104(b)(1) requires inspections to be conducted "annually with respect to each registered public accounting firm that regularly provides audit reports for more than 100 issuers; and * * * not less frequently than once every three years with respect to each registered public accounting firm that regularly provides audit reports for 100 or fewer issuers." Further, Section 104(b)(2) provides that "the Board may conduct special inspections at the request of the Commission or upon its own motion." To implement Section 104(b) of the Act, the Board has proposed two types of inspections – those conducted on a regularly scheduled basis, or "regular inspections" and those conducted at the request of the Board or the Commission, or "special inspections."^{4/}

In conducting an inspection, Section 104(d) of the Act directs the Board to take the following steps: (1) inspect and review selected audit and review engagements of the firm (which may include audit engagements that are the subject of ongoing litigation or other controversy between the firm and one or more third parties) performed at various offices and by various associated persons of the firm,^{5/} as selected by the

^{3/} Rule 4000.

^{4/} Rules 4001 and 4002.

^{5/} The Board's Rule 1001(p)(i) defines "associated person of a public accounting firm" as "any individual proprietor, partner, shareholder, principal,

Board, (2) evaluate the sufficiency of the quality control system of the firm, and the manner of documentation and communication of that system by the firm, and (3) perform such other testing of the audit, supervisory and quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board.^{6/}

Consistent with Section 104(d), the Board's proposed rules provide that a regular inspection will include, but is not limited to, the steps and procedures as specified in Sections 104(d)(1) and (2) of the Act and any other tests of the audit, supervisory, and quality control procedures of the firm as the Director of the Division of Registration and Inspections or the Board determines appropriate.^{7/} In addition, proposed Rule 4002 provides for special inspections that will include all steps and procedures necessary or appropriate to address the issue or issues raised by the Board when it authorized the inspection.^{8/}

accountant, or professional employee of a public accounting firm, or any independent contractor that, in connection with the preparation or issuance of any audit report –

- (1) shares in the profits of, or receives compensation in any other form from, that firm; or
- (2) participates as agent on behalf of such accounting firm in any activity of that firm;

provided, however, that these terms do not include a person engaged only in clerical or ministerial tasks or a person whom the public accounting firm reasonably believes is a person primarily associated with another registered public accounting firm."

^{6/} See Sections 104(d)(1), (2) and (3) of the Act.

^{7/} Rule 4001.

^{8/} Rule 4002.

2. In general, the Board's staff will conduct regular inspections either annually or triennially and special inspections as appropriate to address issues that come to the Board's attention.

Consistent with Sections 104(b)(1) and (2) of the Act, the frequency of the regular inspections will depend on the number of U.S. public companies for which the registered public accounting firm issues or plays a substantial role in the preparation or furnishing of audit reports. Specifically, Section 104(b)(1) of the Act provides that "inspections * * * be conducted * * * annually with respect to each registered public accounting firm that regularly provides audit reports for more than 100 issuers * * * and not less frequently than once every 3 years with respect to each registered public accounting firm that regularly provides audit reports for 100 or fewer issuers." Furthermore, Section 104(b)(2) of the Act provides that the Board may, by rule, adjust the statutory inspection schedule in Section 104(b)(1), if it finds that "different inspection schedules are consistent with the purpose of the Act, the public interest and protection of investors."

Consistent with Section 104(b)(1) of the Act, the Board has proposed the following inspection schedule –

- Beginning no later than the year after its registration with the Board has been approved, a registered public accounting firm that issued audit reports for more than 100 U.S. public companies will be subject to an annual regular inspection.^{9/}
- Beginning with the three-year period following the calendar year in which its registration with the Board has been approved, a registered public accounting firm that issued audit reports for at least one, but no more than 100 U.S. public companies, or that played a substantial role in the preparation or furnishing of audit reports for any U.S. public companies, will be subject to regular inspection once every three years.^{10/}

^{9/} Rule 4003(a). The frequency of a firm's regular inspections will be determined according to the volume of its relevant audit-related work in the preceding year.

^{10/} Rule 4003(b).

Section 104(b)(2) of the Act authorizes the Board to adjust the statutory inspection schedule if such adjustments are consistent with the purposes of the Act, the public interest, and the protection of investors. The proposed rules would make such an adjustment in the case of two classes of registered public accounting firms – (1) those that have voluntarily registered with the Board and do not issue, or play a substantial role in the preparation or furnishing of, a U.S. public company audit report, and (2) those that are registered with the Board but have pending before the Board a request for leave to withdraw their registration. For the reasons explained below, the Board has found that the proposed adjustments to the statutory inspection schedule are necessary to take into account the nature of the practice of these firms and that the adjustments meet the requirements of Section 104(b)(2).

In the case of registered firms that do not engage in public company auditing, the Board does not believe that inspections would accomplish the objectives of the Act. Section 104(c) directs the Board to design its inspection program to assess compliance in connection with a firm's performance of U.S. public company audits, the issuance of U.S. public company audit reports, and related matters involving U.S. public companies. These goals could not be accomplished if the firm under inspection does not participate in public company audits. Therefore, the Board believes that it is consistent with the Act and in the public interest not to subject such a firm to a regular inspection until the firm actually becomes involved in the business of issuing, or playing a substantial role in the preparation or furnishing of, audit reports for a U.S. public company. For this reason, Rule 4003 is silent with respect to any schedule for regular inspections of firms with no public company audit clients.^{11/}

In the case of registered firms that are seeking to withdraw from registration, similar reasoning applies. Under the Board's separately proposed rule relating to withdrawal from registration, such a firm would be designated as "registered –

^{11/} The Board does not encourage the registration of firms that have no public company clients and are not actively seeking to develop a public company clientele. In the future, the Board may consider requiring de-registration of firms that, for an extended period, do not audit, or play a substantial role in the audit of, any public company and do not engage in any other activity that requires registration. See "Frequently Asked Questions Regarding Registration With the Board," Question #8 (July 18, 2003).

PCAOB Release No. 2003-013
July 28, 2003
Page 7

withdrawal request pending" and would not be permitted to issue or play a substantial role in the issuance of U.S. public company audit reports. The Board believes that it would be consistent with the Act and in the public interest for the Board to exercise discretion in determining whether to commence a regular inspection of a firm that has filed a Form 1-WD, rather than strictly hold the firm to the same inspection schedule as other registered firms.

Special inspections are not subject to an inspection schedule and will be conducted at such time as is necessary or appropriate to address issues that come to the Board's attention.^{12/} The Board expects that special inspections may be commenced, based on information that comes to the attention of the Board or its staff in any way, including public company filings with the Commission, 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. A registered public accounting firm may be subject to a special inspection irrespective of the timing of such firm's regular inspection schedule.

3. The Board may refer information learned in inspections to other authorities and may commence an investigation or disciplinary proceeding on the basis of such information.

Section 104(c) of the Act requires the Board to promulgate rules on procedures regarding possible violations. Specifically, Section 104(c) states that "[t]he Board shall, in each inspection * * * and in accordance with its rules for such inspection: (1) identify any act or practice or omission to act by the registered public accounting firm, or by any associated person thereof, revealed by such inspection that may be in violation of [the] Act, the rules of the Board, the rules of the Commission, the firm's own quality control policies, or professional standards; (2) report any such act, practice, or omission, if appropriate, to the Commission and each appropriate State regulatory authority; and (3) begin a formal investigation or take disciplinary action, if appropriate, with respect to any such violation, in accordance with [the] Act and the rules of the Board."

To implement Section 104(c) of the Act, the Board is proposing Rule 4004. Under Rule 4004, if the Board determines that an inspection of a registered public accounting firm reveals a possible violation as described in Section 104(c) by the

^{12/} Rule 4002.

registered public accounting firm, any of its associated persons, or any other person, the Board will, if appropriate (1) report the possible violation to the Commission and each state or other authority that has issued a license or certification number authorizing such person or firm to engage in the business of auditing or accounting, and (2) commence an investigation or a disciplinary proceeding in accordance with the Act and under its rules. Reporting to the Commission and relevant licensing or certification authorities will be subject to Section 105(b)(5)(B) of the Act, which provides that the information provided by the Board shall maintain its status as confidential and privileged in the hands of both the Board and the agency to which the Board reports it. Rule 4004 specifically implements Section 104(c) of the Act. Section 104(c), however, does not limit the Board's authority to refer information, as appropriate, to other authorities not specified in Section 104(c), such as those other authorities identified in Section 105(b)(5)(B). Accordingly, a note to Rule 4004 indicates that the Board may also make referrals other than those to the Commission and relevant licensing or certification authorities.^{13/}

4. The Board and its staff will prepare an inspection report in connection with an inspection.

To implement Sections 104(f) and (g) of the Act, the Board has proposed rules that provide that at the conclusion of an inspection, the Director of the Division of Registration and Inspections will submit to the Board a written draft inspection report. These rules also set forth the process by which a draft inspection report will be submitted to a firm under review in order that the firm may submit any comments or other views concerning the draft report. After reviewing any such submission, the Board will issue a final inspection report.^{14/} The firm's response to the draft inspection report shall be attached to and made part of the inspection report. Section 104(g)(2) of the Act requires the Board to make final inspection reports available to the public in appropriate detail, subject to specific exclusions for confidential and proprietary information, information shielded by Section 105(b)(5)(A) of the Act, and portions of the report dealing with criticisms or potential defects in the quality control systems of the firm under inspection.

^{13/} Rule 4004.

^{14/} Rules 4007(b) and (c).

5. Quality control defects or criticisms described in an inspection report will not be made public if the firm addresses them to the Board's satisfaction within 12 months of the report.

If an inspection report includes criticisms of, or describes potential defects in, a firm's quality control systems, those portions of the inspection report may be made public only if the firm fails to address those matters to the Board's satisfaction within 12 months of the issuance of the final inspection report. Consistent with Section 104(g)(2), proposed Rule 4009 provides that, no later than 12 months after the issuance of the Board's final inspection report, firms may submit to the Director of the Division of Registration and Inspections evidence that they have improved such quality control systems, and remedied such defects. After reviewing such evidence, the Director must advise the firm whether he or she will recommend to the Board that the firm has satisfactorily addressed the criticisms or defects in the quality control system of the firm identified in the final inspection report and, if not, why not.^{15/}

6. The Board may publish reports concerning the procedures, findings, and results of its inspections generally.

Under the proposed rules, the Board may, at any time, publish summaries, compilations, and general reports concerning the procedures, findings, and results of its various inspections. These reports may include discussion of criticisms of, or potential defects in, quality control systems of any firm or firms that were the subject of a Board inspection. Under the proposed rules, these published reports will not identify the firm or firms to which these criticisms relate, or at which the defects were found, unless the information has previously been made public pursuant to the Board's rules or other lawful means.^{16/}

7. Special Issues Relating to Non-U.S. Firms

The rules proposed today apply to inspections of registered public accounting firms. Non-U.S. public accounting firms are not required to be registered until April 19, 2004. As the Board has previously announced, the nature and scope of the Board's oversight over non-U.S. accounting firms that audit the financial statements of U.S.

^{15/} Rule 4009(a).

^{16/} Rule 4010.

public companies will be the subject of dialogue between the Board and its foreign counterparts. The Board is committed to finding ways of accomplishing the goals of the Act without subjecting non-U.S. firms to unnecessary burdens or conflicting requirements. The Board's proposed rules are not intended in any way to signal that the Board has already determined how its oversight should operate as to those firms, or to preclude any adjustments to the rules that may be appropriate in light of those discussions.

B. Opportunity for Public Comment

Interested persons are encouraged to submit their views to the Board. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 006 in the subject or reference line and should be received by the Board no later than 5:00 PM (EDT) on August 18, 2003.

* * *

On the 28th day of July, 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
Acting Secretary

July 28, 2003

APPENDICES –

1. Proposed Rules Relating to Inspections
2. Section-by-Section Analysis of Proposed Inspection Rules

Appendix 1 – Proposed Rules Relating to Inspections

RULES OF THE BOARD

SECTION 1. GENERAL PROVISIONS

Rule 1001. Definitions of Terms Employed in Rules.

When used in Rules, unless the context otherwise requires:

(p)(iv) Professional Standards

The term "professional standards" means –

(A) accounting principles that are –

(i) established by the standard setting body described in section 19(b) of the Securities Act of 1933, as amended by the Act, or prescribed by the Commission under section 19(a) of the Securities Act of 1933 or section 13(b) of the Securities Exchange Act of 1934; and

(ii) relevant to audit reports for particular issuers, or dealt with in the quality control system of a particular registered public accounting firm; and

(B) auditing standards, standards for attestation engagements, quality control policies and procedures, ethical and competency standards, and independence standards (including rules implementing Title II of the Act) that the Board or the Commission determines –

(i) relate to the preparation or issuance of audit reports for issuers; and

(ii) are established or adopted by the Board under section 103(a) of the Act, or are promulgated as rules of the Commission.

SECTION 4. INSPECTIONS

Rule 4000. General.

Every registered public accounting firm shall be subject to all such regular and special inspections as the Board may from time-to-time conduct. Inspection 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.

Rule 4001. Regular Inspections.

In performing a regular inspection, the staff of the Division of Registration and Inspections and any other person authorized by the Board to participate in the inspection shall take such steps, and perform such procedures, as the Board determines are necessary or appropriate in order to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with the Act, the Board's rules, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers. Such steps and procedures must include, but need not be limited to, those set forth in Section 104(d)(1) and (2) of the Act and such other tests of the audit, supervisory, and quality control procedures of the firm as the Director of the Division of Registration and Inspections or the Board determines.

Rule 4002. Special Inspections.

In performing a special inspection, the staff of the Division of Registration and Inspections and any other person authorized by the Board to participate in the inspection shall take such steps, and perform such procedures, as are necessary or appropriate concerning the issue or issues specified by the Board in connection with its authorization of the special inspection.

Note: Under Section 104(b)(2) of the Act, the Board may authorize a special inspection on its own initiative or at the request of the Commission.

Rule 4003. Frequency of Inspections.

(a) During each calendar year, beginning no later than the calendar year following the calendar year in which its application for registration with the Board is approved, every registered public accounting firm that, during the prior calendar year, issued audit reports with respect to more than 100 issuers shall be subject to a regular inspection.

(b) At least once in every three calendar years, beginning with the three-year period following the calendar year in which its application for registration with the Board is approved, every registered public accounting firm that, during any of the three prior calendar years, issued an audit report with respect to at least one, but no more than 100, issuers, or that played a substantial role in the preparation or furnishing of an audit report with respect to at least one issuer, shall be subject to a regular inspection.

(c) With respect to a registered public accounting firm that has filed a completed Form 1-WD under Rule 2107, the Board shall have the discretion to forego any regular inspection that would otherwise commence during the period beginning on the fifth day following the filing of the completed Form 1-WD and continuing until the firm's registration is deemed withdrawn or the firm withdraws the Form 1-WD.

Rule 4004. Procedure Regarding Possible Violations.

If the Board determines that information obtained by the Board's staff during any inspection indicates that the registered public accounting firm subject to such inspection, any associated person thereof, or any other person, may have engaged, or may be engaged, in any act, practice, or omission to act that is or may be in violation of the Act, the rules of the Board, any statute or rule administered by the Commission, the firm's own quality control policies, or any professional standard, the Board shall, if it determines appropriate –

(a) report information concerning such act, practice, or omission, subject to the provisions of Section 105(b)(5)(B) of the Act, to –

(1) the Commission; and

- (2) each state, agency, board, or other authority that has issued a license or certification number to the firm or person who engaged, or may have engaged, in such act, practice, or omission authorizing such firm or person to engage in the business of auditing or accounting; and

(b) commence an investigation of such act, practice, or omission in accordance with Section 105(b) of the Act and the Board's rules thereunder or a disciplinary proceeding in accordance with Section 105(c) of the Act and the Board's rules thereunder.

Note: The Board may, as appropriate, make referrals other than those specifically described in Rule 4004.

Rule 4005. Record Retention and Availability.

[Reserved]

Rule 4006. Duty to Cooperate With Inspectors.

Every registered public accounting firm, and every associated person of a registered public accounting firm, shall cooperate with the Board in the performance of any Board inspection. Cooperation shall include, but is not limited to, providing access to, and the ability to copy, any record in the possession, custody, or control of such firm or person and providing, by oral interview, written response, or otherwise, 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.

Rule 4007. Procedures for Firm Review of and Response to Draft Inspection Report and Issuance of Final Inspection Report.

(a) At the conclusion of each inspection, the Director of the Division of Registration and Inspections shall submit to the Board a written draft inspection report.

(b) Unless the Board directs that transmittal be deferred, the Director shall transmit the draft report to the firm under review. The firm may, within the 30 days following transmittal of the draft inspection report, submit to the Board by letter a

response to the draft report. Any portion of the firm's response that the firm believes is confidential within the meaning of the last sentence of Section 104(f) of the Act must be set forth in a separate document accompanying, but not included within, the firm's response letter.

Note: A firm may identify information in its response as confidential and may supply any supporting authority or other justification for according confidential treatment to the information. Consistent with Section 104(f), the Board shall protect the information from disclosure only if it is reasonable to characterize the information as confidential.

(c) After receiving and reviewing any response letter pursuant to paragraph (b) of this rule, the Board shall issue a final written inspection report. Prior to issuance of the final inspection report, the Board may take such action with respect to the draft inspection report as it considers appropriate, including adopting the draft report as the final report, revising the draft report, or continuing or supplementing the inspection before issuing a final report. In the event that, prior to issuing a final report, the Board directs the staff to continue or supplement the inspection or revise the draft report, the Board may, in its discretion, afford the firm the opportunity to review any revised draft inspection report.

Rule 4008. Transmittal of Final Inspection Report.

Promptly following the Board's issuance of a final inspection report, the Board shall transmit a copy of such final report –

- (a) to the firm that is the subject of the report;
- (b) to the Commission; and
- (c) in appropriate detail, to 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.

In the case of reports transmitted pursuant to paragraphs (b) and (c) of this rule, the report may be accompanied by any additional letter or comments by the Board or the

Board's inspector that the Board deems appropriate. In the case of reports transmitted pursuant to (c), the Board may omit from the report any information the disclosure of which could interfere with any investigation, prosecution, or disciplinary proceeding.

Rule 4009. Firm Response to Quality Control Defects.

(a) Following the receipt of any final inspection report that contains criticisms of, or potential defects in, the quality control systems of the firm under inspection, the firm may submit to the Director of the Division of Registration and Inspections evidence that it has improved such systems, and remedied such defects no later than 12 months after the issuance of the Board's final inspection report. After reviewing such evidence, the Director shall advise the firm whether he or she will recommend to the Board that the Board determine that the firm has satisfactorily addressed the criticisms or defects in the quality control system of the firm identified in the final inspection report and, if not, why not.

(b) After the Board makes its final determination, the Board shall notify the firm of its final determination concerning whether the firm has addressed the criticisms or defects in the quality control system of the firm identified in the final inspection report to the satisfaction of the Board.

(c) The portions of the Board's inspection report that deal with criticisms of or potential defects in quality control systems that the firm has not addressed to the satisfaction of the Board shall be made public by the Board –

(1) upon the expiration of the 12-month period described in paragraph (a) of this rule if the firm fails to make any submission pursuant to paragraph (a); or

(2) upon the expiration of the period in which the firm may seek Commission review of any board determination made under paragraph (b) of this rule, if the firm does not seek Commission review of the Board determination; or

(3) unless otherwise directed by Commission order or rule, 15 days after the firm formally requests Commission review pursuant to Section 104(h)(1)(B) of the Act.

PCAOB Release No. 2003-013
July 28, 2003
Appendix 1 – Rules
Page A1-vii

Rule 4010. Board Public Reports.

Notwithstanding any provision of Rules 4007, 4008, and 4009, the Board may, at any time, publish such summaries, compilations, or other general reports concerning the procedures, findings, and results of its various inspections as the Board deems appropriate. Such reports may include discussion of criticisms of, or potential defects in, quality control systems of any firm or firms that were the subject of a Board inspection, provided that no such published report shall identify the firm or firms to which such criticisms relate, or at which such defects were found, unless that information has previously been made public in accordance with Rule 4009, by the firm or firms involved, or by other lawful means.

Appendix 2 – Section-by-Section Analysis of Proposed Inspection Rules

There are 10 inspection rules (PCAOB Rules 4000 through 4010, with Rule 4005 reserved) plus a related definition (PCAOB Rule 1001(p)(iv)). Each of the rules is discussed below.

Proposed Inspection Rules

Rule 1001 – Definitions of Terms Employed in Rules

Professional Standards

The definition of professional standards in Rule 1001(p)(iv) references that in Section 2(a)(10) of the Act. It should be noted that the term "professional standards" is broader than "auditing and related professional practice standards," which is defined in Rule 1001(a)(viii) of the Board's rules.

Rule 4000 – General

Consistent with Section 104(a) of the Act, Rule 4000 subjects every registered public accounting firm to all such regular and special inspections as the Board may from time-to-time conduct. The rule provides that inspection steps and procedures will be performed by the staff of the Division of Registration and Inspections and by such other persons authorized by the Board.

Rule 4001 – Regular Inspections

Rule 4001 requires that in performing a regular inspection, the staff of the Division of Registration and Inspections and other authorized persons take such steps

and perform such procedures as the Board determines are necessary or appropriate in order to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with the Act, the Board's rules, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers. The rule requires the inclusion of steps and procedures set forth in Sections 104(d)(1) and (2) of the Act and such other tests of the audit, supervisory, and quality control procedures of the firms as the Director of the Division of Registration and Inspections or the Board determines.

Section 104(d)(1) requires the Board to "inspect and review engagements of the firm (which may include audit engagements that are the subject of ongoing litigation or other controversy between the firm and 1 or more third parties), performed at various offices and by various associated persons of the firm, as selected by the Board." Section 104(d)(2) requires the Board to "evaluate the sufficiency of the quality control system of the firm, and the manner of documentation and communication of that system by the firm."

Rule 4002 – Special Inspections

Rule 4002 requires that in performing a special inspection, the staff of the Division of Registration and Inspections and other authorized persons take such steps and perform such procedures, as are necessary or appropriate concerning the issue or issues specified by the Board in connection with its authorization of the special inspection. A note to the rule makes clear that under Section 104(b)(2) of the Act, the Board may authorize a special inspection on its own initiative or at the request of the Commission.

Rule 4003 – Frequency of Inspections

Rule 4003 sets forth the schedule for regular inspections. Rule 4003(a) is consistent with the schedule for larger registered public accounting firms set forth in Section 104(b)(1)(A) of the Act. This rule requires that beginning no later than the year after its registration with the Board has been approved, a registered public accounting firm that, during the prior calendar year, issued audit reports with respect to more than 100 issuers will be subject to a regular inspection. Rule 4003(b) is consistent with the schedule for smaller registered public accounting firms set forth in Section 104(b)(1)(B) of the Act. Rule 4003(b) requires that beginning with the three-year period following the calendar year in which its registration with the Board has been approved, a registered public accounting firm that, during any of the three prior calendar years, issued audit

PCAOB Release No. 2003-013
July 28, 2003
Appendix 2 – Section-by-Section Analysis
Page A2-iv

reports with respect to at least one, but no more than 100, issuers, or that played a substantial role in the preparation or furnishing of an audit report with respect to at least one issuer, will be subject to a regular inspection.

In accordance with Section 104(b)(2), the Board is proposing Rule 4003(c) which adjusts the regular inspection schedule for a registered public accounting firm that has requested to withdraw from registration by filing a completed Form 1-WD.^{1/} Specifically, the rule provides that the Board shall have discretion not to conduct a regular inspection that would otherwise commence during the period beginning on the fifth day following the filing of the completed Form 1-WD and continuing until the firm's registration is deemed withdrawn or the firm withdraws its Form 1-WD.

Rule 4004 – Procedure Regarding Possible Violations

Consistent with Section 104(c) of the Act, Rule 4004 sets forth procedures which the Board is required to follow with respect to possible violations by firms under inspection. Specifically, the rule requires that if the Board determines that information obtained by the Board's staff during any inspection indicates that the registered public accounting firm subject to such inspection, any associated person thereof, or any other person, may have engaged, or may be engaged in any act, practice, or omission to act that is or may be in violation of the Act, the rules of the Board, any statute or rule

^{1/} See PCAOB Release No. 2003-014 (July 28, 2003).

PCAOB Release No. 2003-013
July 28, 2003
Appendix 2 – Section-by-Section Analysis
Page A2-v

administered by the Commission, the firm's own quality control policies, or any professional standard, then the Board shall, if it determines it appropriate, report such possible violations to the Commission and each state or other authority that has issued a license or certification number authorizing such person or firm to engage in the business of auditing or accounting. Reporting to the Commission and other relevant authorities will be subject to Section 105(b)(5)(B) of the Act, which preserves the privileged and confidential nature of information that is referred by the Board.

In addition, under Rule 4004, if the Board determines it appropriate, the Board shall commence an investigation of such act, practice, or omission in accordance with Section 105(b) of the Act and the Board's rules thereunder or commence a disciplinary proceeding in accordance with Section 105(c) of the Act and the Board's rules thereunder.

The phrase "if it determines appropriate" in Rule 4004 means that the Board will decide which of these acts, practices and omissions would be appropriate to refer to the Commission and to the states or other authorities. In making this determination, depending on the nature of the possible violation, the Board could conclude that it may be appropriate to refer something to the Commission, and not the states or other authorities, and vice versa. A note to the rules makes clear that the Board may, as appropriate, make referrals other than those specifically described in Rule 4004.

PCAOB Release No. 2003-013
July 28, 2003
Appendix 2 – Section-by-Section Analysis
Page A2-vi

Rule 4005 – Record Retention and Availability

Section 104(e) of the Act provides that the "rules of the Board may require the retention by registered public accounting firms for inspection purposes of records whose retention is not otherwise required by Section 103 or the rules issued thereunder." The Board is reserving this rule in anticipation of issuing standards on record retention as part of its standard setting process once it has experience with its inspection program. Registered public accounting firms should continue to comply with other applicable federal, state and professional record retention requirements.

Rule 4006 – Duty to Cooperate with Inspectors

Rule 4006 requires every registered public accounting firm and every associated person of such firm to cooperate with the Board in any Board inspection. The rule requires that such firms and persons must, among other things, provide access to, and the ability to copy certain records and provide such other relevant or material information as may be requested by the Board's inspectors.

Rule 4007 – Procedures for Firm Review of and Response to Draft Inspection Report and Issuance of Final Inspection Report

Rule 4007(a) requires the Director of the Division of Registration and Inspection to submit to the Board a written draft inspection report. Rule 4007(b) also requires that the Director to transmit the draft report to the firm under review, unless the Board directs

PCAOB Release No. 2003-013
July 28, 2003
Appendix 2 – Section-by-Section Analysis
Page A2-vii

that transmittal be deferred. This paragraph of the rule permits the firm, within 30 days following transmittal of the draft inspection report, to submit to the Board by letter any comments, objections, recommended revision, or other views concerning the draft report. The rule requires that any portion of the firm's response that the firm believes is confidential be set forth in a separate document accompanying, but not included within, the firm's response letter.

A note to Rule 4007(b) points out that a firm that identifies any information in its response as confidential may supply any authority or justification for according confidential treatment to the information, but that the Board will not protect such information from disclosure unless it is reasonable to characterize the information as confidential. The Board anticipates that a substantial portion, if not all, of a firm's response will be directed to the portions of the report that deal with criticisms and potential defects in the firm's quality controls. For as long as the Board is required to keep those portions of the report confidential (12 months if the criticisms and potential defects are not satisfactorily addressed, indefinitely if they are addressed), the Board would, without the firm needing to make a specific request, maintain the confidentiality of the portions of the firm's response that address those matters. To the extent that a firm's response includes other matters, the Board will grant the firm's confidentiality

request to the extent that the Board determines that it is reasonable to treat the information as confidential.

Rule 4007(c) requires the Board to issue a final written inspection report after receiving and reviewing any response letter submitted by the firm pursuant to paragraph (b) of the rule. Prior to the issuance of the final inspection report, however, the rule permits the Board to take such action with respect to the draft report as it considers appropriate. For example, it may adopt the draft report as the final report, revise the draft report, or continue or supplement the inspection before issuing a final report. If the Board directs the staff to continue or supplement the inspection or revise the draft report, the Board may, in its discretion, afford the firm the opportunity to review any revised draft inspection report.

Rule 4008 – Transmittal of Final Inspection Report

Consistent with Section 104(g)(1) of the Act, Rule 4008(a) requires the Board to transmit a copy of the final inspection report to the firm that is the subject of the report, to the Commission, and in appropriate detail to 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. The rule makes clear that in the case of reports transmitted to the Commission or other relevant authority, the report may be accompanied by an additional letter or comments by the Board or its inspector. Also, in

the case of reports transmitted to a licensing or certification authority, the rule permits the Board to omit from the report any information the disclosure of which could interfere with any investigation, prosecution or disciplinary proceeding.

Rule 4009 – Firm Response to Quality Control Defects

Consistent with Section 104(g)(2) of the Act, Rule 4009(a) permits a firm that has received a report that contains any discussion of criticisms of, or potential defects in, the firm's quality control systems to submit to the Director of the Division of Registration and Inspections evidence that it has improved such quality control systems, and remedied such defects. This submission must be made no later than 12 months after the issuance of the Board's final inspection report. The rule requires the Director, after reviewing the evidence, to advise the firm whether he or she will recommend to the Board that the firm has satisfactorily addressed the criticisms or defects in the quality control system of the firm identified in the final inspection report and, if not, why not.

Rule 4009(b) requires the Board to notify the firm of its final determination as to whether the firm has addressed to the satisfaction of the Board the criticisms or defects in the firm's quality control system.

Rule 4009(c) provides that the Board will make public those portions of a final inspection report dealing with such criticisms and defects if the firm fails to address those matters to the Board's satisfaction within 12 months of the issuance of the final

PCAOB Release No. 2003-013
July 28, 2003
Appendix 2 – Section-by-Section Analysis
Page A2-x

inspection report. Rule 4009(c) specifically addresses the time of any such public disclosure. Under Rule 4009(c), if a firm made no submission to the Board under Rule 4009(a) concerning the firm's efforts to address the criticisms or potential defects, then the Board would make those portions of the report public upon the expiration of the 12-month period. If the firm made a submission under Rule 4009(a), but then failed to seek Commission review of an adverse Board determination concerning that submission within the time allowed to seek such review, the Board would make those portions of the report public upon the expiration of the period allowed for seeking Commission review. If the firm did timely seek Commission review, under Section 104(h)(1)(B) of the Act, of an adverse Board determination, the Board would make those portions of the report public 15 days after the firm formally requested Commission review, unless the Commission, by rule or order, directs otherwise. The Board is proposing the 15-day delay, subject to any superseding Commission rule or order, to allow the Commission an opportunity to consider whether to order a longer stay of public disclosure in a particular case, since the Act does not operate to stay such disclosure.

Rule 4010 – Board Public Reports

Rule 4010 permits the Board, at any time, to publish public summaries, compilations, or other general reports concerning the procedures, findings, and results of its various inspections as the Board deems appropriate. The rule allows for these

PCAOB Release No. 2003-013
July 28, 2003
Appendix 2 – Section-by-Section Analysis
Page A2-xi

reports to include discussion of criticisms of, or potential defects in, quality control systems of any firm or firms that were the subject of a Board inspection. However, the rule prohibits these published reports from identifying the firm or firms to which these criticisms relate, or at which the defects were found, unless the information has previously been made public pursuant to the Board's rules or other lawful means.