PCAOB
Public Company Accounting Oversight Board

December 20, 2010

The Honorable Mary L. Schapiro
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: The Public Company Accounting Oversight Board's 2010 Inspections Documentation and Other Selected Issues (IOPA-2010-003) (December 20, 2010)

Dear Chairman Schapiro:

I am pleased to transmit a summary of a performance review entitled, The Public Company Accounting Oversight Board's 2010 Inspections Documentation and Other Selected Issues. The Board's Office of Internal Oversight and Performance Assurance ("IOPA") conducted this performance review. The Board formed IOPA to provide the Board, the Securities and Exchange Commission, and others interested in the Board's work, with assurance that the Board is achieving the objectives of Title I of the Sarbanes-Oxley Act ("Act") in an effective manner. IOPA conducts its reviews in conformance with Government Auditing Standards issued by the Comptroller General of the United States.

Background of IOPA's Inspections Documentation Review

In a March 2009 report to Board Chairman Olson, the Commission's Office of Compliance Inspections and Examinations ("OCIE") and Office of Chief Accountant ("OCA") recognized the Board's achievements in establishing, in a relatively short period timeframe since the passage of the Act, an operational program of inspections designed to meet the criteria in the Act. The report noted that the PCAOB had made improvements to that program over time and had demonstrated a commitment to further improvements. The Commission's staff also concluded, however, that the PCAOB's documentation policies and practices resulted in insufficient evidence of the inspection process and hindered the ability of the SEC staff to evaluate the effectiveness of the inspection program. The OCIE/OCA report contained recommendations aimed at addressing this and other issues.

In late 2009, the Commission's staff requested that IOPA follow-up on aspects of the OCIE/OCA review. In particular, the staff asked that IOPA focus on whether PCAOB inspectors were in fact implementing, during the 2010 inspections season, certain changes the Board had agreed to make in its inspections documentation. IOPA met and discussed with the Commission's staff a proposed scope of review, and that review is reflected in IOPA's report. IOPA also decided to include in its review follow-up on aspects of its 2009 report on international inspections.[1] IOPA conducted its review from May to October 2010.

IOPA Findings

Based on its work, IOPA found that the Division of Registration and Inspections ("Division") had made the agreed-to changes in those inspections procedures that were within the scope of the review and had made a good-faith effort to implement those changes in 2010. In addition, with respect to the Commission staff's documentation-related recommendations, IOPA concluded that, in its judgment, the risks that the OCIE/OCA report had identified associated with subsequent SEC staff review of inspection procedures had been reduced. IOPA also noted that the Division had taken actions responsive to the concerns that IOPA had raised in 2009 regarding the documentation of international inspections.

IOPA's review does, however, highlight questions regarding how inspection staff resources are managed and related morale issues in the Division. Specifically, IOPA concluded that initial implementation of the revised documentation policies appeared to have severely stressed the Division's resources and that the revised documentation approach -- although aggressively and systematically adopted and implemented -- may not be fully compatible with the Division's existing models for staff scheduling and assignments.

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[1] The Public Company Accounting Oversight Board's International Inspections (IOPA-2009-003) (December 4, 2009). In that report, IOPA noted, among other things, that key decisions about international inspections were often not well documented. IOPA made recommendations to the Division aimed at improving international inspections documentation.

Response to IOPA Report

I am pleased that IOPA found that the Division has adopted and implemented the above-referenced changes to its procedures. As to the additional issues IOPA has raised, we are taking action at both the Division level and the Board level to address the findings and recommendations in IOPA's report.[2]

In the case of the Division, Division leadership became aware of staff concerns regarding scheduling, timekeeping, resource allocation and morale issues, consistent with those identified in IOPA's report, at the same time as IOPA was conducting its review. These concerns were compounded by the fact that the Division had recently undergone significant changes to enhance its international inspection program.[3] In early summer 2010, Division leadership established a plan to seek feedback on these issues through meetings with the inspections staff in all of the Board's regional offices. From these meetings, it became clear that the Division's approach to staffing and scheduling needed to be revisited to accommodate the new approach to documentation, particularly in light of the significant changes to its non-U.S. program. The Division acted to address these matters, including asking the Division's Regional Office Committee (which includes representatives of both headquarters leadership and of all regional offices) to analyze and address the staff's concerns. The Division's efforts, which have expanded to include responding to the specific recommendations in IOPA's report, are ongoing. I have scheduled a series of meetings over the next several months at which the Division will brief the Board on its plans and progress.

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[2] In addition to the steps described below, the Board's 2011 budget recognizes additional resource needs related to the matters addressed in the IOPA report. In particular, the 2011 Budget funds an additional 15 positions in the Division to respond to recent changes in the Board's inspection methodology and documentation requirements.

[3] My letter transmitting the public summary of IOPA's report on international inspections highlighted some of these changes and explained that the Board's reassessment of its non-U.S. inspection program had resulted in significant alterations in the manner in which these inspections would be performed in the future. See Letter to Mary L. Schapiro, Chairman, Securities and Exchange Commission, from Daniel L. Goelzer, Acting Chairman, Public Company Accounting Oversight Board (December 14, 2009).

In order to provide the Board with additional perspective and advice on the matters raised in the IOPA report, I have established the Inspections Management Working Group ("IMWG"), which will be chaired by the Board's Chief Administrative Officer. I have directed the IMWG to review the Division's response to IOPA's recommendations and to independently advise the Board regarding steps to address issues identified in the IOPA report. I have asked the IMWG to make an initial report to the Board no later than February 15, 2011.

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In summary, the Division has made significant, good-faith efforts to implement changes in its program in response to OCIE/OCA's and IOPA's recommendations. The IOPA report recognizes those achievements, but also identifies a series of related issues that could affect the continuing success and effectiveness of our inspection program, if not promptly and thoroughly addressed. The Board values the dedication and talent of its Inspections staff and is committed to identifying and implementing ways to address the challenges facing the Division.

The Board intends to publish the attached summary of IOPA 2010-003 on the Board's Web site on December 27, 2010, or shortly thereafter. You and your staff should feel free to contact me or the Director of IOPA, Peter Schleck (202-207-9085), if you have any questions or would like any additional information about this review.

Sincerely,

Daniel L. Goelzer
Acting Chairman

Enclosure: The Public Company Accounting Oversight Board's 2010 Inspections Documentation and Other Selected Issues (IOPA-2010-003) (December 20, 2010)

cc: The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

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PERFORMANCE REVIEW

THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S 2010 INSPECTIONS DOCUMENTATION AND OTHER SELECTED ISSUES (IOPA-2010-003)

INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE
December 20, 2010

Background and Objective

The Public Company Accounting Oversight Board's *Strategic Plan 2009 – 2013* calls for an inspection program that identifies deficiencies in audit, quality control, ethics, and other concerns at registered public accounting firms, and that determines whether firms have appropriately remediated identified problems. The *Plan* envisions high quality inspections, inspection reports that are timely, and methodologies for performing and documenting inspections that continue to improve over time.

Reports issued in 2009 by Securities and Exchange Commission (SEC) staff[1/] and Internal Oversight and Performance Assurance (IOPA)[2/] included a number of recommendations intended to assist in the ongoing improvement of inspection performance and documentation.

In its March 2009 report, the SEC staff recognized the significant achievements of the PCAOB in establishing, in a relatively short timeframe since the passage of the Sarbanes-Oxley Act, an operational program of inspections designed to meet the criteria established in the Act. The report noted that the PCAOB had made improvements to its program over time and demonstrated a commitment to making continuing improvements.

[1/] *Inspection of the Public Company Accounting Oversight Board's Inspection Program*, SEC Office of Compliance Inspections and Examinations and Office of the Chief Accountant, March 19, 2009.

[2/] *Review of the Public Company Accounting Oversight Board's International Inspections*, IOPA-2009-003, December 2009.

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The SEC staff also concluded, however, that the PCAOB's documentation policies and practices resulted in insufficient documentation to evidence the inspection process and hindered the ability of the SEC staff to evaluate the effectiveness of the PCAOB's inspection program. The staff reported that it identified numerous deficiencies with respect to compliance with documentation policies and procedures. Furthermore, according to the report, policies in place at the time (prior to 2007) did not require teams to document, among other things, the extent and results of the inspection procedures performed and the basis for the conclusions reached. The report contained 27 recommendations aimed at improving the inspection program. The PCAOB responded by developing and implementing a series of corrective actions.

In late 2009, the SEC staff requested that IOPA follow-up on aspects of their review, focused primarily on whether agreed-to changes made by the PCAOB's Division of Registration and Inspections (Division) had been implemented and were being followed by inspectors during the 2010 inspections season. In early 2010, IOPA met and discussed with the SEC staff a proposed scope of review that included follow-up on aspects of 10 of the 27 recommendations.

IOPA also included in our scope of review follow-up on aspects of our own 2009 report on international inspections. In that report, we noted, among other things, that key decisions about international inspections were often not well documented and that in numerous instances, documentation in inspection files was not sufficient to allow a full understanding or a robust defense of the choices made. IOPA made a number of recommendations with which the Division concurred.

IOPA initiated the current review to determine whether the Division was conducting and documenting its 2010 inspections in accordance with its revised policies.[3/] The scope of IOPA's review included 2010 inspections for which field visits had been completed as of September 1, 2010.

Responsibilities and Authorities

Section 104 of the Sarbanes-Oxley Act of 2002 requires the PCAOB to conduct a continuing program of inspections to assess registered firms with regard to the

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[3/] This is a public summary of the report. The full report, prepared in accordance with Government Auditing Standards, has been issued to the Board. The full report includes a detailed discussion of the review objective, scope, and methodology.

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performance of audits and related matters. Inspections are to be performed annually for firms that provide audit reports for more than 100 issuers and at least once every three years for most other registered firms that prepare issuer audit reports. The PCAOB is required to provide a written report for each inspection to the SEC, and to make portions of the reports publicly available.

The Act further specifies that, in conducting inspections, the PCAOB:

- Inspects and reviews selected audit and review engagements of the firm performed at various offices and by various associated persons of the firm.

- Evaluates the sufficiency of the quality control system of the firm.

- Performs other testing of the audit, supervisory, and quality control procedures of the firm, as necessary.

Section 4 of the Rules of the PCAOB established that Division staff will implement these provisions of the Act by taking such steps and performing such procedures as the Board determines necessary or appropriate. In accordance with the Act and Board Rules, the Division has established and implemented an array of policies and procedures, many of which are captured in separate manuals covering large-firm, small-firm, and international-firm inspections.[4/]

Results in Brief

Based on the identified need to enhance the documentation of its inspections, the Division developed and, beginning with the 2010 inspection season, implemented changes to its policies and procedures regarding such documentation. The new approach was applied to all types of inspections – large firms, small firms, and international firms – and added or modified forms and templates associated with each. The Division's intent was to create a more complete written record of each inspection, including such information as:

[4/] Large-firm inspections are also referred to as "annual." Small-firm inspections are also referred to as "triennial." These terms reflect the Act's requirements regarding inspection frequency. As of the date of IOPA's review, all international firms were considered to be triennial.

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- Which PCAOB inspection staff performed, reviewed, and approved key inspections procedures;
- Whether assigned staff members were independent with respect to the firm and issuers inspected;
- Assessment and evaluation of the inspected firm's quality control;
- Inspection teams' rationale for selecting issuers and areas of emphasis to inspect;
- Descriptions, for each area of emphasis, of the inspected firm's assessment of related risk; testing of controls; and substantive testing;
- Methodologies, including the use of PCAOB-developed inspection guides, used to inspect and evaluate the firm's audit procedures;
- Inspection teams' conclusions regarding the adequacy of the firm's audit procedures;
- Inspection matters, if any, requiring consultation between the inspection team and Division leadership or other experts.

The Division acted aggressively and systematically to adopt and implement the revised documentation approach. The 2010 inspection documentation IOPA reviewed complied with revised policies and procedures and created a record for subsequent review that was better organized, more consistent, and more robust than in previous years. In this respect, the Division's actions were responsive to the concerns we raised in 2009. The inspection files we reviewed in 2010 contained evidence that was sufficient for subsequent reviewers to understand how inspectors made such decisions as what issuers and areas of emphasis to inspect. With regard to the SEC staff's documentation-related recommendations, IOPA concluded that within the scope of our review, the Division made agreed-to changes in procedures and a good-faith effort to implement those changes. Risks associated with subsequent review of inspection procedures have, in our judgment, been reduced.

IOPA also concluded, however, that initial implementation of the revised policies appeared to have severely stressed the Division's resources. Specifically, evidence suggested that the revised documentation approach may not be fully compatible with existing models for scheduling and assigning staff to inspections. For example, we noted that:

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- Inspectors and team leaders with whom we spoke estimated that documenting inspections in 2010 required 10 percent to 60 percent more time than in previous years.

- The scheduling model, which allows for one field week for most domestic triennial and non-US firm inspections, was essentially the same as that used for 2009. However, inspectors and team leaders told IOPA that conducting and documenting a "typical" inspection in these categories is no longer possible with just one week in the field.

- Inspectors involved in both annual and triennial firm inspections expressed frustration that the time now devoted to completing required documentation detracts from their ability or inclination to exercise their judgment or depart, if appropriate, from the inspection plan conceived prior to field work. As such, their experience and talent, they believe, are undervalued and underutilized as compared to previous years.

Management may have significantly underestimated the resources required to implement the enhanced approach to documenting inspections. Moreover, in spite of substantial anecdotal evidence that resources were strained, the Division had not acted to collect more precise data that would allow a better understanding of whether or not adjustments to staffing, scheduling, or inspection scope were needed.

IOPA recognized that the Division was in the midst of its first-year implementation of the revised documentation policies and that meaningful analysis of the new approach and its effects will take more time. In fact, senior Division management expressed openness to adjusting documentation, scheduling, or staffing, as appropriate, once such analysis is performed after the completion of 2010 inspections.

IOPA's review disclosed an additional matter, however, that has the potential to more seriously impede the Division's efforts to objectively analyze and address the noted issues. We observed what appeared to be a pervasive concern about whether Division management fostered an appropriate tone at the top. For example, specific comments made to IOPA, and also documented by the Division itself, suggested to us that Division leadership had delivered the message that it did not want to document total hours worked, that it was inflexible regarding scheduling, and that it discouraged candid discussion about such issues. Intentional or not, such a message can only be counterproductive to the collection of objective, reliable data. Without such data, an

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understanding of how best to balance the documentation, scheduling, and staffing of PCAOB inspections will be difficult to obtain.

During 2010, the Director initiated actions to address these and related concerns using the Division's Regional Office Committee. The Committee's work was ongoing at the time of our review.

IOPA made recommendations intended to help address the issues raised in this report. In a written response, the Director commented on the issues and expressed general support for IOPA's recommendations.