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## **BRIEFING PAPER**

### **PROPOSED RULES ON INVESTIGATIONS AND ADJUDICATIONS**

#### **PROPOSED RULES ON INSPECTIONS OF REGISTERED PUBLIC ACCOUNTING FIRMS**

#### **PROPOSED RULE ON WITHDRAWAL FROM REGISTRATION**

### **JULY 28, 2003 PUBLIC MEETING OF THE BOARD**

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At its public meeting on July 28, 2003, the Public Company Accounting Oversight Board will consider whether to propose and seek comment on rules relating to investigations and adjudications, rules governing inspections of registered public accounting firms, and a rule on the process by which a registered public accounting firm may seek to withdraw from registration.

#### **Proposed Rules on Investigations and Adjudications**

Section 105 of the Sarbanes-Oxley Act of 2002 grants the Board broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms, and directs the Board to establish, by rule, fair procedures for the investigation and discipline of such firms and persons. To implement this authority, the Board will consider proposing, and seeking comment on, rules relating to investigations and adjudications.

Under the proposed rules, the Board and its staff could conduct investigations concerning any act or practice, or omission to act, by a registered public accounting firm or person associated with such a firm, that may violate any provision of the Act, the rules of the Board, certain provisions of the securities laws, or professional standards. As provided in the Act, the proposed rules would require registered public accounting firms and their associated persons to cooperate with Board investigations. The proposed rules would also, per the Act, permit the Board to seek information from other

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persons, including clients of registered firms and, should those persons not comply, to seek issuance of a Securities and Exchange Commission subpoena for the information.

When violations are detected, the Board would provide an opportunity for a hearing, and in appropriate cases, impose sanctions designed to prevent a repetition and to enhance the quality and reliability of future audits. Under the proposed rules, these sanctions could include temporarily or permanently prohibiting a firm or associated person from participating in audits of public companies or from being associated with a registered public accounting firm. The Board could also require special remedial measures, such as training, new quality control procedures, or the appointment of an independent monitor.

The Board may also hold hearings on registration applications, pursuant to Section 102 of the Act. Under the Board's registration rules, if the Board is unable to determine that a public accounting firm's application has met the standard for approval, the Board may provide the firm with a notice of a hearing, which the firm may elect to treat as a written notice of disapproval for purposes of making an appeal to the Commission under Section 107. If such a firm chooses to request a hearing, the Board would, in appropriate circumstances, afford the firm a hearing pursuant to the proposed rules.

The proposal consists of 64 rules (PCAOB Rules 5000 through 5501), plus certain definitions that would appear in Rule 1001. These rules are generally divided into five parts: 1) Inquiries and Investigations, 2) Disciplinary Proceedings, 3) Disciplinary Sanctions, 4) Rules of Board Procedure, and 5) Hearings on Disapproval of Registration Applications.

**Proposed Rules on Inspections of Registered Public Accounting Firms**

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 that firm's associated persons, with the Act, the rules of the Board, the rules of the Commission, and professional standards, in connection with the performance of audits, the issuance of audit reports, and related matters involving U.S. public companies. The Board will consider proposing rules that would establish a general procedural framework for a program of inspections.

Under the rule proposal, the Board would conduct two types of inspections of registered public accounting firms – "regular" inspections and "special" inspections. Regular inspections will take place at regular intervals (described below) and will

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include, among other things, review of selected audit and review engagements of the firm, and evaluations of the sufficiency of the firm's quality control system. A special inspection may be authorized by the Board or requested by the Commission at any time as to any firm, and will involve the steps and procedures necessary or appropriate to address issues specified in the authorization or request.

The proposed rules provide that the Board will conduct regular inspections either annually or triennially, depending on the size of a firm's practice relating to the issuance of audit reports for U.S. public companies. In general, a registered public accounting firm that annually issues audit reports for more than 100 U.S. public companies would be subject to an annual inspection, while any other firm that issues, or plays a substantial role in preparing or furnishing, an audit report for any U.S. public company would be subject to inspection every three years.

Under the proposed rules, the Board and its staff will prepare an inspection report in connection with an inspection. The proposed rules set forth the process by which a draft inspection report will be submitted to the firm in order that the firm may submit any comments on the draft before the Board issues a final report. The proposed rules, tracking the provisions of the Act, also provide that portions of a final report that deal with criticisms or potential defects in a firm's quality control system will not be made public if the firm addresses them to the Board's satisfaction within 12 months of the report.

The proposed rules include a provision for the Board to publish summary, compilation, or other general reports concerning the procedures, findings, and results of its various inspections. These reports may discuss findings and concerns related to the quality control systems of firms inspected by the Board, but these reports would not identify the firms in question, unless the information has previously been made public.

Finally, the proposed rules, like the Act, provide that the Board may refer information learned in inspections to the Commission and to relevant licensing or certification authorities. The rule also provides that the Board may commence an investigation or disciplinary proceeding on the basis of information learned in an inspection.

The proposal consists of 10 rules (PCAOB Rules 4000 through 4010, with Rule 4005 reserved).

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### **Proposed Rule on Withdrawal from Registration**

On May 6, 2003, the Board adopted rules relating to a registration system for public accounting firms. The Commission approved those rules on July 16, 2003. Those rules provide procedures by which firms may seek to register with the Board, but they do not provide any procedures by which a firm, once registered, may seek to withdraw from registration. The Board will consider a proposed rule that would supply those withdrawal procedures.

Under the proposed rule, a registered firm may seek to withdraw its registration by filing a request with the Board on the appropriate Board form, Form 1-WD. A firm that files a Form 1-WD may not, unless it first withdraws its Form 1-WD filing, engage in the preparation or issuance of, or play a substantial role in the preparation or furnishing of, an audit report for a U.S. public company. This restriction is necessary to avoid the risk that the Board would grant a pending withdrawal request at a time when the firm is in fact engaged in conduct for which registration is required.

Withdrawal is not automatic upon request. There are important reasons, in the public interest and for the protection of investors, that the Board may choose to delay a firm's withdrawal in certain circumstances. For example, a firm might seek to withdraw to avoid a sanction in an ongoing disciplinary proceeding or to avoid an imminent inspection for a period with respect to which the firm has concerns about its conduct. The proposed rule therefore automatically delays a firm's withdrawal in certain circumstances and, in other circumstances, allows the Board the flexibility to delay withdrawal for up to two years.

If the Board does delay a firm's withdrawal, the proposed rule would nevertheless ease certain registration-related burdens on the firm during the delay. Specifically, the annual reporting requirements and annual fee obligations would be reduced to essentially nothing. Moreover, the Board would have the discretion to waive any regular inspection of the firm that would otherwise commence, according to the Board's inspection schedule, during the delay.

The proposed rule would also allow the Board to void a firm's withdrawal, and reinstate the firm's registration, if the Board discovers information indicating that the firm may have made a material misstatement or omission in its Form 1-WD. If, for example, the firm fails to disclose on Form 1-WD an ongoing criminal investigation related to its audit work, and the Board discovers that omission after the Board has already allowed the firm to withdraw, the Board may void that withdrawal, reinstate the firm's registration,

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and take such investigative and other steps as may be appropriate in light of the Board's responsibilities with respect to registered accounting firms.

The proposal consists of one rule (PCAOB Rule 2107).

**Public Comment**

Written comments on any of the three rule proposals 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](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). Comments on the proposed rules on investigations and adjudications should refer to PCAOB Rulemaking Docket Matter No. 005 in the subject or reference line, comments on the proposed rules on inspections should refer to PCAOB Rulemaking Docket Matter No. 006, and comments on the proposed rule on withdrawal from registration should refer to PCAOB Rulemaking Docket Matter No. 007. All comments should be received by the Board no later than 5:00 PM (EDT) on August 18, 2003.

The Board will consider the comments, modify its proposals as it deems appropriate, and submit the proposals to the Commission for approval pursuant to Section 107 of the Act. The Board's proposed rules will not take effect unless approved by the Commission.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.