CCH Coverage of audit standards and board actions

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McDonough Selected to Head PCAOB

The SEC on April 15 announced the selection of William J. McDonough to chair the Public Company Accounting Oversight Board, subject to the completion of a background investigation. McDonough was the unanimous choice of the commissioners who all attended the announcement of his selection. McDonough is currently the president of the Federal Reserve Bank of New York. He said that upon final approval by the Commission, he will attempt to wrap up his work at the New York Fed by the latter part of May. McDonough said he was anxious to go to work at the PCAOB.

Donaldson said the reason McDonough was the Commission's choice for PCAOB chair was his expertise in difficult situations, his integrity and his dedication to public service.

SEC Chairman William Donaldson had made the appointment of a new PCAOB chairman his top priority. He said that with the help of his fellow commissioners, the SEC has found someone who not only meets the criteria outlined in the Sarbanes-Oxley Act but also lives up to the additional standards they all agreed were important.

Following the announcement of his nomination at the SEC, McDonough and Donaldson answered questions. Asked about his background in accounting, McDonough said it was more as a practitioner and an observer. He has served as chair of the Basle Committee, and added that he "adores accounting theory."

McDonough was asked about his statement that the PCAOB must be a tough overseer to protect the public's interest and ensure that any inappropriate behavior has ended. He said he didn't know yet how tough the PCAOB will have to be. If accounting firms are not getting the message, the PCAOB will take tough action, according to McDonough. It is important that the profession is aware that the PCAOB will be tough, but McDonough predicted it would not be necessary to be tough for very long.

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SEC Actions

SEC Finds That PCAOB Satisfies Requirements of the Sarbanes-Oxley Act

On April 25, the SEC issued an order in which it determined that the Public Company Accounting Oversight Board has satisifed the requirements of the Sarbanes-Oxley Act and is prepared to undertake its statutory responsibilities (Rel. No. 33-8223). The SEC also issued a policy statement in which it reaffirmed the status of the Financial Accounting Standards Board as a designated private sector standard setter as required under section 108 of the Act (Rel. No. 33-8221). Finally, the SEC approved the interim professional standards proposed by the PCAOB, which satisfy section 103 of the Act (Rel. No. 33-8222).

The qualifications of each member of FAF and FASB are critical if FASB is to continue to be a premier private sector standard-setting body.

The PCAOB on April 16 proposed interim auditing, attestation, quality control, ethics and independence standards which it believes satisfy the requirements of the Act. The interim standards are taken from existing accounting literature. The interim standards were approved by the SEC and will remain in effect until they are modified or superceded by the PCAOB or the SEC. The SEC found that the adoption of the interim standards is consistent with the requirements of the Sarbanes-Oxley Act and the federal securities laws. Any new professional standards that relate to the audit of public companies must be approved by the PCAOB under its statutory rulemaking process, published for comment and approved by the SEC.

The Sarbanes-Oxley Act established criteria that must be met in order for the work product of an accounting standard-setting body to be recognized as "generally accepted." Among the required criteria is that the standard-setting body must be organized as a private entity, must have an independent board of trustees, must be funded as provided for in the Act, and must have procedures to ensure prompt consideration of changes in accounting principles. The board also must consider the extent to which international convergence on high quality accounting standards is appropriate when adopting accounting principles.

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PCAOB *Reporter*

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PCAOB Adopts Rules on Auditor Registration

At a recent public meeting, the Public Company Accounting Oversight Board adopted final rules relating to a registration system for accounting firms, including non-U.S. firms. The PCAOB did not grant a blanket exemption from registration to foreign accounting firms because registration is the "predicate to all the Board's other oversight programs," it said. Thus, exempting non-U.S. accounting firms from registration would be equal to exempting them from any oversight, the PCAOB concluded.

All public accounting firms that plan to prepare or issue audit reports on U.S. public companies, or play a substantial role in the preparation and furnishing of such reports, must register with the PCAOB.

According to the rules, all public accounting firms that plan to prepare or issue audit reports on U.S. public companies, or play a substantial role in the preparation and furnishing of such reports, must register with the PCAOB. Individual accountants that are associated with firms are not required to register but firms are required to disclose in their registration forms the names of certain accountants who participate in the preparation of audit reports.

In response to comments from foreign interest groups, the PCAOB amended the rules to allow an applicant to withhold information from its application if disclosure of such information would cause the applicant to violate non-U.S. laws. In that case, the applicant should include in the application as an exhibit a copy of the relevant portion of the conflicting non-U.S. law, a legal opinion about the matter and an explanation of the applicant's efforts to seek consents or waivers to eliminate the conflict.

Non-U.S. accounting firms would be required to disclose only those accountants who contribute to the preparation of audit reports for U.S. issuers. In addition, the PCAOB granted foreign firms one year, or until approximately April 26, 2004, to register.

The PCAOB's registration system is expected to be ready to receive applications in July. U.S. accounting firms must be registered at the end of the 180-day period following the SEC's determination that the PCAOB has the capacity to carry out the Sarbanes-Oxley Act's requirements. The SEC issued an order on April 25 stating that the PCAOB has satisfied the requirements of the Act. According to the rules, the PCAOB must approve a firm's application, issue a written notice of a hearing or request more information from the applicant within 45 days after receipt of the application. A written notice of a hearing will specify the proposed grounds for disapproval, which the applicant may choose to treat as a disapproval and appeal to the SEC. Due to the 45-day review period, the PCAOB advised U.S. accounting firms to file their applications no later than early September to ensure Board action before the October deadline.

The PCAOB amended the rules to narrow the types of criminal, civil and administrative proceedings that are required to be disclosed. For U.S. firms, the amended rules require the disclosure of proceedings involving the applicant or any

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Rulemaking

PCAOB Adopts Funding Rules, Proposes Auditing Standards and Ethics Code

On April 16, the Public Company Accounting Oversight Board adopted rules relating to public company funding of the board's operations as required under the Sarbanes-Oxley Act. The PCAOB also proposed an ethics code governing the conduct of its members, employees and certain consultants and professional standards for registered public accounting firms.

Under the newly adopted rules, the accounting support fee, as it is known under the Act, will be allocated to, and payable by, two classes of issuers. The first group comprises publicly traded companies with average monthly U.S. equity market capitalizations during the preceding year, based on all classes of common shares, of greater than $25 million. The second batch is made up of investment companies with average monthly U.S. equity market capitalizations of greater than $250 million. The PCAOB notes that investment companies will be assessed at a lower rate because of their structure and the relatively simpler nature of their audits. All other issuers, including those that are not required to file audited financial statements with the Commission, employee share purchase, savings and similar plans and bankrupt issuers that file modified reports, will not be required to contribute.

The fee must be allocated in a way that reflects the proportionate size of the issuers and it must be distributed equitably.

Under the final rule, which is awaiting Commission approval, the PCAOB will calculate the accounting support fee annually. The fee will be equal to the PCAOB's budget for that year, as approved by the Commission, less the amount of registration and annual fees received during the previous year from public accounting firms. In establishing the rules, the PCAOB said that it was guided by two principles under section 109 of the Act which generally state that the fee must be allocated in a way that reflects the proportionate size of the issuers and that it must be distributed equitably.

Once the amount of fees to be obtained is determined, issuers will be required to pay their share on the 30th day after receiving notification from the PCAOB. Issuers disagreeing with the calculations may offer a written petition to the board for a correction. If an issuer does not pay its dues by the 60th day after a notice is sent, the board may report the issuer's non-payment to the Commission, which could result in administrative, civil or criminal sanctions.

The PCAOB's rules also require that no registered public accounting firm may sign an unqualified audit opinion with respect to an issuer's financial statement if that issuer has outstanding dues and if the issuer has not filed a petition for a correction of its share of the accounting support fee.

The PCAOB received eight comment letters in response to the proposed rules and has revised certain aspects of the rules to accommodate commenters' concerns. Specifically, the revisions would explain that "average monthly market capitalization" will be based on closing prices on the

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European Union Concerned Over PCAOB Audit Registration

Decrying the decision by the Public Company Accounting Oversight Board to require European Union-based audit firms with U.S.-listed clients to register with the board, European Commissioner for the Internal Market Frits Bolkestein called for a moratorium on the registration of EU audit firms so that effective international solutions can be found to restore market confidence without imposing disproportionate burdens on EU businesses and audit firms. The PCAOB decision still needs to be considered and approved by the SEC.

Commissioner Bolkestein said that registration of EU audit firms is unnecessary because the union has equivalent and adequate systems in place to deal with registration, oversight and external quality assurance of auditors. While the EC shares the goal of having effective audit systems in place in order to prevent accounting irregularities and restore investor confidence, the commissioner emphasized that this should be done on the basis of mutual recognition of equivalent oversight systems. The EC believes that the PCAOB's approach may lead to mounting pressure to require U.S. audit firms to register in the EU.

The PCAOB rules require the registration of U.S. audit firms by October 2003 and foreign audit firms by May 2004. Failing this, it would be unlawful for audit firms to perform audit work in relation to issuers in the U.S., including some 280 EU companies with a dual listing in the U.S. as well as the union. According to the EC, the draft rules imply that all major EU audit firms will have to register with the PCAOB, that the personal data of tens of thousands of people working for the audit firms should be transferred to the U.S. and that the audit firms have to give access to audit working papers and any audit client documents.

While recognizing that the PCAOB has adopted an elaborate procedure to avoid a situation where foreign audit firms would have to break laws in their jurisdiction, the EC emphasized that, given the number of serious legal issues, the information which could be provided by EU audit firms is very limited. This situation serves to reinforce the EC's view that rigorous home country control over audit firms is a far more effective way to protect investors.

The EC pledged to come forward soon with a communication on priorities for audits in the EU to continue and reinforce its initiatives on statutory audits over the last years. The communication will be considered in parallel with a broader Communication on Corporate Governance. ■

James Hamilton

Timeline:

- April 15, 2003—Selection of William McDonough to chair the PCAOB
- April 15, 2003—Adoption of funding rules; proposed ethics code, statement of policy on the standard-setting process
- April 23, 2003—Adoption of registration system for public accounting firms
- April 25, 2003—SEC finds that PCAOB satisfies the requirements of the Sarbanes-Oxley Act; reaffirms the status of the FASB and FAF as designated private sector standard setters under the Act; approves interim professional standards
- May 9, 2003—Comments due on proposed code of ethics
- May 12, 2003—Comments due on standard-setting process

Industry Views

ICI Supports PCAOB Fee Scheme for Investment Companies

In the view of the Investment Company Institute, the recent action by the Public Company Accounting Oversight Board to assess investment companies support fees at a lower rate than other issuers is an equitable approach recognizing that audits of investment companies are relatively less complex than audits of other issuers. The ICI believes that a reduced assessment rate for investment companies is entirely appropriate given the simple and straightforward accounting and auditing processes applicable to funds and the overlay of substantive regulation imposed by the Investment Company Act, combined with periodic on-site inspections by SEC staff.

> *ICI believes that a reduced assessment rate for investment companies is entirely appropriate given the simple and straightforward accounting and auditing processes applicable to funds.*

Section 109(d) of the Sarbanes-Oxley Act authorizes the board to establish rules for the equitable allocation, assessment and collection of fees among issuers. The Act allows for appropriate differentiation in the process. The PCAOB proposal envisions a four-tiered classification system with investment companies in a separate category. One major class would capture public companies with market capitalizations greater than $25 million. A second class would consist of investment companies and business development companies with market capitalizations of greater than $250 million. The proposed funding system rules will not take effect until approved by the SEC.

Issuers subject to the fee would be allocated a share of the board's budget based on their market capitalization (or net assets) relative to total equity market capitalization (including fund net assets). For purposes of this allocation, the market capitalization of an investment company issuer will be 10% of net asset value, resulting in a lower assessment on investment companies.

The ICI told the board that the 10% fee rate under the proposal is appropriate. The relative amount of audit fees paid by issuers is a sound indicator of the complexity and risk associated with an audit, the ICI reasoned, and also provides a reliable basis for estimating the amount of time and resources the board will likely devote to different classes of issuers. A comparison of audit fees paid by investment companies relative to their net assets and audit fees paid by public companies relative to their market capitalization revealed that audit fees paid by large investment companies amounted to 2.54% of those paid by large public companies Audit fees paid by small investment companies amounted to 13.45% of audit fees paid by small public companies. Taken together, emphasized the ICI, this indicates that assessing investment companies at a rate of 10% of that assessed public companies is appropriate. ■

James Hamilton

SEC Acting Chief Accountant Sees Major Issues For PCAOB

Noting that the Public Company Accounting Oversight Board has undertaken the immense and extremely important task of restoring confidence in the independent audit, Acting SEC Chief Accountant Jackson Day detailed a number of critical issues the board will have to deal with in the coming months. In remarks at the Baruch College Conference on Financial Reporting, Day said that the board will have to resolve the gap between investors' expectations and auditors' professional requirements. In addition, the PCAOB must determine the who, what, when, where and how of inspecting registered accounting firms. And importantly, he emphasized that the PCAOB is challenged to resolve the issues related to foreign audit firms and the foreign affiliates of U.S. audit firms.

The staff is actively working on the final rule implementing Section 404 on internal control reporting and hopes to make a recommendation to the Commission soon.

In remarks earlier this year before the New York State Society of CPAs, the chief accountant explained that implementation of a quality inspection program may be the oversight board's most important challenge. While the Sarbanes-Oxley Act provides that the largest firms must be inspected each year and other firms every third year, the board must decide how many partners will be reviewed each time the firm is reviewed, what functions will be reviewed, and whether risk will be a determinate in answering those questions. The board also must consider the effects of its timing in light of the seasonality of the auditing business.

There is also the question of who will perform the inspections. The oversight board must determine if it will perform all inspections or contract some of them out, Day said, and what effect the required internal inspections should have on their work. The board also must address the issue of resources and how to get the expertise necessary to tackle issues such as computer auditing, independence, client acceptance and continuance, technical accounting consultations, and auditing fair value estimates.

At the Baruch seminar, Day pledged that the SEC will work with the PCAOB to ensure that it carries out its mission effectively and efficiently so that these critical issues can be addressed in a meaningful manner. The oversight board has a distinct advantage over the infrastructure that previously existed, he noted, in that it is independent in fact and appearance and that inspection, discipline and audit standard setting all reside in one place.

Shifting gears to discuss the implementation of the Sarbanes-Oxley Act, which created the PCAOB, the chief accountant said that the staff is actively working on the final rule implementing Section 404 on internal control reporting and hopes to make a recommendation to the Commission soon. After that, there are just a few odds and ends with respect to the Sarbanes-Oxley rulemaking initiatives, and then the SEC will essentially be done with rulemaking, which Day described as

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PCAOB Satisfies Requirements

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The SEC's policy statement on FASB found that its financial accounting and reporting standards are recognized as "generally accepted" for purposes of the federal securities laws. Registrants are required to continue to comply with those standards in preparing financial statements that are filed with the SEC. FASB has developed accounting principles and standards since its formation in 1973. The SEC also found that the Financial Accounting Foundation, which oversees FASB's funding and appoints its members, meets the criteria of the Sarbanes-Oxley Act and serves the public interest.

The SEC said that FAF and FASB should give it timely notice of FAF's intention to appoint new members to either body. FAF will make the final determination with respect to members, but should consider the SEC's views in making its selection. The qualifications of each member of FAF and FASB are critical if FASB is to continue to be a premier private sector standard-setting body, according to the policy statement.

FASB should take reasonable steps to continue to improve its timeliness in completing projects, the SEC advised, and should continue to be objective in its decision making. It should carefully weigh the views of all of its constituents as well as the costs and benefits of each standard.

The SEC's endorsement of FASB will allow it to begin coordinating with the PCAOB to implement the funding mechanisms of Sarbanes-Oxley Act section 109. ■

Jacquelyn Lumb

Rules on Auditor Registration

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associated person whereas foreign firms should disclose proceedings involving persons who provide 10 or more hours of audit services for an issuer.

Acting Chairman Charles D. Niemeier said the PCAOB faced a difficult decision as to whether to require registration by non-U.S. accounting firms. In his view, the role of non-U.S. accounting firms in U.S. markets is already too critical to exclude those firms from the purview of the PCAOB's programs with a blanket exemption. Board member Daniel L. Goelzer assured that the PCAOB is not requiring registration of foreign firms because it believes that regulatory structures in other countries are deficient. He said, however, that strong and effective foreign regulation is not a reason to exempt foreign firms from registration.

Soon after the meeting, European Union Internal Market Commissioner Frits Bolkestein commented on the rules saying that he regrets the PCAOB's decision to require registration by foreign firms. He said that the best way forward would be a moratorium on the registration of EU audit firms so that effective international solutions can be agreed upon without imposing disproportionate burdens on EU businesses and audit firms. He said that this approach would lead to a better fulfillment of the PCAOB's mandate of protecting investors in the U.S. because its chosen approach may lead to mounting pressure to require U.S. audit firms to register in the EU. That would not be in the interest of the audit firms or the investors who ultimately pay for the cost of registration, Bolkestein said.

At the meeting, the PCAOB also approved a budget for this year and a request that the SEC determine that it has the capacity to carry out its responsibilities under the Sarbanes-Oxley Act. ■

Anna Kallioinen

PCAOB Adopts Funding Rules

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last day of each month measured, and the number of shares outstanding will be reported in the issuer's periodic filings with the Commission. The PCAOB also clarified that issuers whose market capitalization is not reported publicly on a regular basis will be explicitly excluded from paying the fee. The PCAOB also stated that the auditor's obligation to confirm that its public company has paid its fees may be satisfied by obtaining a written representation from the issuer.

Ethics Code

The PCAOB's proposed ethics code establishes rules and standards of conduct for its members, staff and certain consultants. The PCAOB stated that while the code's restrictions in most cases are directed at professional staff to reflect the difference in responsibilities and pay levels, all employees will be bound by duties of confidentiality.

The PCAOB outlined the guiding principles that must be observed to ensure compliance with the proposed code. For instance, employees must always be aware of the gravity of the board's responsibilities and the need to maintain the public's confidence in the independence and objectivity of the board. The PCAOB warned against using a position on the board or any confidential information gleaned in the course of the job for private gain.

The PCAOB also contemplates putting in place certain protections to address potential conflicts of interest that may arise among candidates hired from the private sector areas that will be most affected by the board's work. Among other things, the proposed code prohibits all financial obligations to or from a former employer, business partner or client, except in certain circumstances. The PCAOB plans to designate an Ethics Officer to enforce the code who will be empowered to counsel board members and staff regarding compliance and violations. In addition, the ethics code represents a condition of employment with the board. Board members and staff will be required to certify annually that they are in compliance with the code.

The PCAOB also announced the process it will use to establish auditing and other professional standards for registered public accounting firms. The board's standard-setting process will include the appointment of an advisory group to help in formulating new standards and in reviewing existing standards. However, the PCAOB has decided not to exercise the authority granted to it under section 103 of the Act to designate any professional group of accountants to propose standards.

The proposed ethics code and standard setting process are open for comment until May 9 and May 12, respectively. ■

Namrata Savoor

McDonough Selected

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When asked whether the PCAOB would set audit standards, McDonough said he didn't know the answer yet. It is important to know what you do not know, he said.

In response to a question about the PCAOB's autonomy from the SEC, McDonough said the degree of autonomy is established by statute. He added that if the PCAOB carries out its responsibilities as well as it should, the SEC will have confidence in the organization.

Donaldson said the reason McDonough was the Commission's choice for PCAOB chair was everyone's awareness of his expertise in difficult situations, his integrity and his dedication to public service.

McDonough was recently asked to serve on the New York Stock Exchange board, but will not take a seat on the board, given his decision to serve as the PCAOB chair. As for getting a late start with the PCAOB, McDonough said the board so far has made good decisions and good hires. His greatest challenge, he said, is to have college graduates a couple of years from now believe it would be great to work for an accounting firm because accounting is where the very best people want to work. ■

Jacquelyn Lumb

SEC Acting Chief Accountant

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phase one. Implementation will then have to be monitored and, if necessary, interpretative guidance provided. Further, he believes that the process is iterative and may require a review in two or three years to see how everything is working. Noting that adjustments may have to be made, Day declared that regulatory vigilance and flexibility are key to the success of all of these reforms.

Finally, Day remarked that international convergence is occurring, citing the intention of the European Union to require the use of international accounting standards by 2005. In his view, the standard-setting process now underway may be the easiest element of international convergence to make happen. It is the other elements of the global financial reporting infrastructure that need at least equal focus, he said, including high quality auditing and auditing standards, effective oversight of standard setters and auditors, independence of auditors, and ethics and competence on the part of auditors. ■

James Hamilton