PCAOB

Public Company Accounting Oversight Board

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November 30, 2004

By Hand Delivery
The Honorable William H. Donaldson
Chairman
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549

Dear Chairman Donaldson:

I am very pleased to transmit to you a summary of the Public Company Accounting Oversight Board's latest performance review, conducted by the Board's Office of Internal Oversight and Performance Assurance. The Board formed IOPA to provide the Board, the Securities and Exchange Commission, and others assurance that the PCAOB is achieving the objectives of Title I of the Sarbanes-Oxley Act in an effective manner.

This performance review focuses on the Board's significant investment in information technology. IOPA made a number of recommendations intended to help strengthen IT governance. Efforts to implement these recommendations are under way.

From the beginning, the PCAOB has made a commitment to integrate information technology into all of its programs, including the four core responsibilities set out in the Sarbanes-Oxley Act: registration, inspections, standards-setting and enforcement. The Board's registration system for public accounting firms is Web-based, permitting small firms and large firms to report the same data in different formats, depending on their own needs. In addition, PCAOB inspectors and investigators rely heavily on IT systems to record and analyze the data they collect about firms' auditing practices and procedures. Further, the PCAOB's risk-assessment program requires sophisticated IT applications that apply pattern-matching and other risk analysis techniques to uncover trends and subtle relationships in data the PCAOB collects. Finally, the vast audience affected by PCAOB actions – accounting firms, investors, fellow regulators and the public, both in the United States and around the world – requires that we have a robust and effective IT communications system, including a Web site that features live webcasts of PCAOB events and easy access to PCAOB proposals, public comments on those proposals, and final standards and rules.

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In developing the business model for the PCAOB's information technology, the PCAOB has followed an approach that matches technology deployment with organizational development. Systems are acquired or constructed as requirements are determined. The initial requirements for audit firm registration and Board funding, for example, were driven by statutory deadlines. Much of what the organization requires today in the areas of operations, application delivery and security continues to be time sensitive. Nevertheless, as we grow our IT capabilities, we remain unwaveringly focused on the benefits of integrating IT into every aspect of our work.

Consistent with IOPA's recommendations regarding the PCAOB's developing information technology, the PCAOB Office of Information Technology –
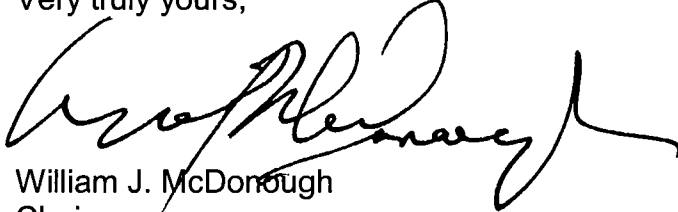
- will implement an IT governance framework to coincide with the delivery and stabilization of key program applications. Documentation of key policies, processes and procedures will be critical to establishing adequate internal control over the effectiveness of the PCAOB's governance framework;

- has commenced the process of developing and implementing its information architecture in order to manage technology and other changes with the least disruption;

- has begun developing comprehensive configuration management and will document this process as part of its IT governance framework;

- has updated its IT organization structure to reflect how and where to employ regular employees and to use contractors. The PCAOB's Chief Information Officer expects to update this structure regularly; and

- will develop measures of effectiveness and goals, as appropriate, for each IT functional area. These measures and goals will be determined through a process of collaboration with users of IT services and, where appropriate, from benchmark data, with appropriate attention to avoiding measures or goals that could drive unintended consequences.

The Board intends to publish the attached summary of IOPA's review on the PCAOB's Web site on Monday, December 6, 2004. You and your staff should feel free

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to contact the Director of IOPA, Peter Schleck (202-207-9115), if you have any questions or would like any additional information about this performance review.

Very truly yours,

William J. McDonough
Chairman

Attachment

cc: Donald T. Nicolaisen

PERFORMANCE REVIEW

INTERNAL CONTROL REVIEW OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S INFORMATION TECHNOLOGY AND SECURITY FUNCTION (IOPA-2004-002)

NOVEMBER 19, 2004, INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE

Background and Objective

In March 2004, Internal Oversight and Performance Assurance completed an initial risk assessment of the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") key programs and functions. Based on that assessment, we designed, and the Board directed us to complete, a series of performance reviews to be conducted during 2004 and 2005. The objective of these reviews is to assess the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls.

In the context of this review, we generally use the term "internal control" as described by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission. The COSO definition includes internal control over the effectiveness and efficiency of operations; compliance with applicable laws and regulations; and, internal control over financial reporting. The primary focus of this review was internal control over the effectiveness and efficiency of IT operations. As such, the review was not designed to allow us to express an opinion on internal controls over financial reporting and did not include detailed tests of compliance.

As part of this and each subsequent review in this series, Internal Oversight and Performance Assurance will identify and report on the current status of internal controls and any plans to add to, enhance, or benchmark those controls against existing

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standards. This report,[1] which focuses on Information Technology ("IT") and Security, is the first in the series.

At the PCAOB, IT operations are the responsibility of the Chief Information Officer ("CIO"), who reports to the Chief Administrative Officer. The IT office is organized into three major components, one each for Operations, Application Delivery, and Security.[2] At the time of our field work, PCAOB records indicated that 27 regular employees and 27 contractor staff reported to the CIO. The PCAOB budgeted $30.8 million for technology, including salaries, in 2004.[3]

The PCAOB is a unique blend of organizational cultures that, by law, was established as a private sector entity and charged with a public interest mission. The Board has articulated a framework of strategic themes that culminates in the restoration of public trust in the audits of publicly held companies. The first building block of that framework, according to the Board, is successful regulatory oversight and enforcement of auditing standards. In our judgment, such success is dependent, at least in part, on the continuing establishment of robust internal standards, policies, procedures, and professional practices to guide PCAOB operations on a day-to-day basis. The ongoing observance of such internal discipline may also communicate to the accounting profession and the public that developing rigorous and appropriately defined standards and practices is of paramount importance.

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[1]   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.

[2]   At the time of our review, all security functions, both physical and technological, were the responsibility of the CIO. As such, use of the terms "IT" or "IT operations" should be understood to include security. As of September 2004, PCAOB had hired a facilities manager who will assume certain responsibilities for physical security.

[3]   As of November 2004, the IT headcount was approximately 31 regular employees and 35 contractor employees. The 2005 budget was approved subsequent to our fieldwork, on October 26, 2004, and included $25.9 million for IT. (According to the Chief Financial Officer, the 2005 IT budget is $35.8 million including salaries.) The 2003 IT budget was $11.1 million exclusive of salaries.

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At the same time, we recognize that Board Members and senior PCAOB staff also hope to foster a creative work environment that eschews bureaucracy while encouraging informed risk-taking and innovative solutions. In conducting these reviews, Internal Oversight and Performance Assurance is supportive of the premise that a principles-based "accountability model" can strike an appropriate balance that demands professional excellence while fully supporting the resourcefulness and entrepreneurial initiative of its employees.

We believe that the COSO definition generally allows sufficient flexibility for managers; however, we recognize that other control frameworks and definitions may also be appropriately used. Finally, we note that COSO's broad-based view of internal controls is consistent with Internal Oversight and Performance Assurance's charter to help insure the efficiency, effectiveness, and integrity of PCAOB programs and operations.

Results of Review

Based on our analysis of over 300 IT-provided documents, discussions with the Chief Information Officer and staff, and interviews with a number of internal "customers," we identified numerous good business practices and positive accomplishments indicative of a high-performing IT function. We noted, for example, that IT had –

- placed business analysts with each major PCAOB program office to facilitate effective requirements development and systems delivery;

- developed and delivered a major application – the web-based registration system[4] – under extremely short timeframes;

- deployed a contractor firm to perform real-time quality assurance over the registration system's development to mitigate risks associated with the accelerated schedule;

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[4] See IOPA-2004-001, *Performance Review of the Public Company Accounting Oversight Board's Registration Process*, July 2004

- routinely performed risk assessments on new applications prior to introduction to the production environment;

- designed, successfully deployed, and continued to service an extensive and complex network; and,

- drafted a number of organization-wide security policies and procedures.

Some of the documents we reviewed, as well as our discussions with the CIO, also indicated that a number of IT governance models, processes, and approaches were under active consideration. In addition, we observed that the Board had been very supportive of IT resource requirements, including the approval of a 2004 IT budget of approximately $31 million.[5] These accomplishments and conditions provide, in our judgment, an excellent environment in which to build a comprehensive infrastructure and control framework.

As may be expected in a start-up mode, much of the success to date, while noteworthy, has been dependent on the heroic efforts of individuals. The challenge now remains to ensure the development and full implementation of well-documented processes that capture good practices, tailor them to the PCAOB context, render them easily repeatable, and guide the measurement of results. Based on our analysis of the documentation provided and on our discussions with senior IT managers, we concluded that PCAOB IT operations are still in the initial maturity stages as described by a number of widely-used models of IT governance, system development, service delivery, and security. Given the extremely tight statute-based timeframes under which the PCAOB was established and is now operating, this status is understandable. As noted, the CIO and staff have achieved substantial successes.

We also concluded, however, that in order to most effectively build on those successes and to maximize the Board's considerable investment in technology, the IT staff should optimize its ongoing efforts to build an internal infrastructure by developing a plan to meet a number of significant challenges in the near future.

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[5] Once approved by the Board, PCAOB annual budgets are submitted to the Securities and Exchange Commission, in accordance with section 109 of the Sarbanes-Oxley Act of 2002, for Commission approval.

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Specific challenges we noted during the review include the need to –

- adopt or develop one or more governance frameworks or models to guide development of infrastructure, process, and control;

- develop, in consultation with key customers, an information architecture;

- enhance configuration management; and,

- implement performance goals and measures and enhance staffing and contracting plans.

The CIO and staff were aware of these challenges and indicated that plans to address each were already under consideration. By continuing the process of addressing these areas and documenting, as appropriate, the results, we believe that the CIO and staff will, in essence, define a strategic approach to information management that will assist the Board in achieving its long-term objectives.

To assist in this process, we made recommendations to the CIO addressing each of the challenges we noted. Management's response discussed the PCAOB's planned approach to further developing an IT governance model and an information architecture, documenting configuration management, and establishing IT-related performance goals.