

May 27, 2005

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 pleased to transmit to you a summary of the Public Company Accounting Oversight Board's most recent 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 human resources function, including efforts to recruit and retain a well-qualified cadre of accountants and other professionals as called for by the Sarbanes-Oxley Act. The review is one in a series that IOPA, at the Board's direction, is conducting to assess the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls.

The PCAOB's success in fulfilling its mandate to oversee the auditors of public companies will be determined by the marshalling of a talented and experienced staff, which in turn will require the work of a vigorous and nimble human resources function. The growth of the organization in its first 18 months of existence illustrates the need for close attention to the Board's human resources. The PCAOB began operations in January 2003 with four Board members and a handful of staff members in a single suite of offices; it began 2004 with five Board members and a staff of 116 in five cities. At the end of 2004, the PCAOB staff numbered 260 in eight cities.

By the end of 2005, we expect to have approximately 450 staff. One of our most significant challenges in the remainder of 2005 is to hire the 80 or so additional inspectors we need to help us conduct approximately 300 inspections of registered public accounting firms that we plan for 2005. To accomplish this significant increase in staff at a time of intense competition for the professionals with the specialized skills needed by the PCAOB, the Board will rely on the recommendations in IOPA's review and continuing assessments of its human resources function to hone its efforts to attract and retain the people who will make it possible to fulfill the Congress's vision for the PCAOB.

PCAOB

Public Company Accounting Oversight Board

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The Board intends to publish the attached summary of IOPA's review on the PCAOB's Web site on Friday, June 3, 2005. You and your staff should feel free 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,

A handwritten signature in black ink, appearing to read "W. J. McDonough", written in a cursive style.

William J. McDonough
Chairman

Enclosure

PERFORMANCE REVIEW

INTERNAL CONTROL REVIEW OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S HUMAN RESOURCE OPERATIONS (IOPA-2005-001)

MAY 26, 2005, INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE

Background and Objective

In 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 over operations. As part of each review, 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 standards. This report,^{1/} which focuses on Human Resource operations, is the second in the series.

Section 101 of the Sarbanes-Oxley Act of 2002 established the Board and provided the basic framework for human resource considerations at the PCAOB. Specifically, the Board was granted the power to ...

appoint such employees, accountants, attorneys, and other agents as may be necessary or appropriate, and to determine their qualifications, define their

^{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.

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duties, and fix their salaries or other compensation (at a level that is comparable to private sector self-regulatory, accounting, technical, supervisory, or other staff or management positions) ...

The statutory language in this instance helps to convey the conceptual design of the PCAOB as a unique blend of organizational cultures that pursues a public interest mission while maintaining the characteristics of a private sector entity. Implicit in this language is the necessity for the PCAOB to successfully compete in the marketplace for well-qualified professional staff.

Consistent with its broader statutory mandate to protect investors and further the public interest by overseeing public company audits, the Board has articulated a framework of strategic themes that culminates in the restoration of public trust in those audits. The Board identified "successful regulatory oversight and enforcement of auditing standards" as the first building block in that framework. Board members and senior staff have consistently made the case that successful accomplishment of the PCAOB's strategic objectives is heavily dependent upon the organization's ability to identify, hire, and retain a cadre of highly qualified, experienced professionals.

In our judgment, an effective approach to human resource management depends, at least in part, on the continuing establishment of robust internal standards, policies, procedures, and professional practices. Further, the ongoing observance of such internal discipline may help communicate to the accounting profession and the public that rigorous and appropriately-defined standards and practices are viewed by the Board as being of paramount importance.

At the same time, we recognize that Board Members and senior PCAOB staff also hope to foster a creative, non-bureaucratic work environment that encourages 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. In this context, we generally use the term "internal control" as defined by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission, reproduced below.

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Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- **Effectiveness and efficiency of operations.**
- **Reliability of financial reporting.**
- **Compliance with applicable laws and regulations.**

While the COSO definition includes internal control relevant to financial reporting, it is important to note that COSO-defined controls also encompass business operations and the legal and regulatory framework in which an entity operates. Our review included all of these aspects of internal control, but it was not designed to allow us to express an opinion on internal controls over financial reporting in accordance with PCAOB Auditing Standard No. 2.

The PCAOB's Human Resources ("HR") function is led by the Director of HR, who reports to the Chief Administrative Officer. The Director's key responsibilities include recruitment, employee development, performance management, and compensation and benefits. The Director also ensures that HR complies with applicable laws and PCAOB procedures. As of December 2004, HR was staffed with 8 regular and 6 temporary employees.

Results of Review

Based on our analysis of documents provided by HR, discussions with the HR Director and staff, and interviews with a number of HR "customers"^{2/} throughout the PCAOB, we identified many positive accomplishments and ongoing initiatives that have facilitated the statutory missions of the PCAOB. We noted, for example, that HR had –

^{2/} HR uses the term "client" to refer to those to whom it provides services. We use the term "customer" for consistency with our other reports in this internal control series.

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- Coordinated an aggressive hiring process that increased PCAOB's total staffing from 173 to 260 regular employees over the last nine months of 2004.
- Developed a "Total Rewards" strategy for employees. The strategy includes a wide variety of initiatives for performance management, benefits, compensation, work/life balance, and related issues.
- Conducted the 2005 benefits Open Enrollment process, in which 75 percent of employees participated using a web-based application developed with the Information Technology staff.
- Negotiated various health, dental, and life insurance benefit enhancements and/or price reductions; and, introduced new types of leave available to employees who become parents, serve in the military reserves, serve as jurors, or experience the loss of a family member.
- Conducted the PCAOB's first performance reviews and its first merit increase cycle.
- Worked to develop a more consistent recruiting message and redesigned the PCAOB's orientation for new employees.
- Developed and implemented certain written policies, including those discussing equal employment opportunity and the prohibition of sexual harassment.

In addition, we observed that the Board had been very supportive of human resource initiatives and the resource requirements of its program leaders, including the approval of a 2005 budget that includes robust staffing goals.

Based on our review, we concluded that among the most critical near term challenges that remain are recruiting – and retaining – the cadre of well-qualified professional and support staff that will be needed to meet Sarbanes-Oxley requirements and the Board's strategic objectives. This is of particular concern as the Board seeks to hire a significant number of experienced accountants in support of its inspections function, which has been called the "cornerstone" of the Board's mission. In this regard,

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we noted that over the last nine months of 2004, the PCAOB added, on average, about nine new employees per month, of which five were inspectors.^{3/} In order to reach its stated goal of 220 inspectors by the end of 2005, the rate of hiring for that specialty will need to increase substantially. Current assumptions regarding attrition at the PCAOB, as well as anecdotal evidence regarding the tight market for experienced accountants, could make this challenge even more pronounced.

Our discussions with senior PCAOB managers and HR customers throughout the organization also led us to conclude that the continued development and implementation of initiatives in the Total Rewards strategy will likely be key in establishing a workforce model in which valued employees are encouraged to view the PCAOB as a long-term career choice. Chief among these initiatives is the further definition of an overall compensation strategy and the development of career paths within various offices. To its credit, HR has been proactive in seeking input, proposing initiatives, and communicating with employees.

As part of our review, we also selected a statistical sample of HR files, in order to test compliance with various legal requirements, as well as the completeness and accuracy of those files and of the HR information system. We found that, for the attributes tested, the files were generally complete and the data in the information system was accurate. There were some employees hired in the Board's initial months who were not subjected to background checks. The HR Director was aware of this fact and indicated that a process to initiate background checks for all such employees would commence no later than April 15, 2005.

Internal Oversight and Performance Assurance made recommendations to the Director of HR intended to assist in the continuing consideration of the issues and challenges associated with recruitment, retention, and related matters. In a joint response to our draft report, the Chief Administrative Officer and the Director of HR indicated that initiatives responsive to our recommendations – involving manpower planning meetings and performance management tools – were underway.

^{3/} During this period, at least 14 other PCAOB elements added staff. The largest staffing increases among these elements included Information Technology, Financial Analysis and Risk Assessment, and the Division of Enforcement and Investigations.