

December 19, 2005

The Honorable Christopher Cox  
Chairman  
Securities and Exchange Commission  
450 5<sup>th</sup> Street, NW  
Washington, DC 20549

Dear Chris:

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. IOPA conducts its reviews in conformance with Government Auditing Standards issued by the Comptroller General of the United States.

This performance review focuses on inspections activities conducted by the Board's Division of Registration and Inspections. The review is one in a series that IOPA is performing to assess the progress of key PCAOB programs and functions in establishing effective and appropriate internal controls.

Based on its review, IOPA concluded that the Division of Registration and Inspections has significant infrastructure in place to guide and communicate the steps and procedures required to conduct inspections. IOPA commented on ongoing development of internal standards, practices, and controls, specifically noting a number of Division initiatives. IOPA also made a number of observations for the division to consider as it continues to develop and enhance the infrastructure supporting the inspections process. In a corollary review, IOPA provided the Division with comments based on a quality assurance assessment of selected 2005 small firm inspections.

The Board is very supportive of IOPA's review process which, in this particular instance, helped to identify a number of successes in the inspections program as well as areas that will benefit from additional attention. In this regard, I am pleased to inform you that the Director of Registration and Inspections plans new enhancements to the inspections process for 2006, including creating a manual for the conduct of large firm inspections; working with the Office of General Counsel to prepare additional guidance regarding the Board's interim document retention policy; preparing a master inventory of all inspection's

The Honorable Christopher Cox  
December 19, 2005  
Page 2 of 2

guidance and information on scheduling, reporting, and related topics; and, distributing training policy and planning documents, along with other periodic communications, to all inspectors.

The Board intends to publish the attached summary of IOPA's review on the PCAOB's Web site on December 27, 2005. You and your staff should feel free to contact me or 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,



Bill Gradison  
Acting Chairman

Enc.

cc: Cynthia A. Glassman, Commissioner  
Paul S. Atkins, Commissioner  
Roel C. Campos, Commissioner  
Annette L. Nazareth, Commissioner

---

---

## **PERFORMANCE REVIEW**

### **INTERNAL CONTROL REVIEW OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD'S INSPECTION ACTIVITIES (IOPA-2005-003)**

**December 14, 2005, INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE**

---

---

#### **Background and Objective**

In 2004 and 2005, Internal Oversight and Performance Assurance completed risk assessments of the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") major programs and functions. Based on those assessments, we designed a series of performance reviews 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 identifies and reports on the current status of internal controls and any plans to add to, enhance, or benchmark those controls against existing standards. Previous reports in this series have discussed controls in place over information technology, human resources, and finance. This report<sup>1/</sup> focuses on the processes established by the Board and the PCAOB's Division of Registration and Inspections to inspect registered accounting firms.

The statutory basis for PCAOB inspections is Section 104(a) of the Sarbanes-Oxley Act of 2002, which provides that –

The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board,

---

<sup>1/</sup> 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.

## **PERFORMANCE REVIEW**

the rules of the [Securities and Exchange] Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.

The Act further specifies that inspections should be conducted annually for firms that regularly provide audit reports for more than 100 issuers, and not less frequently than every three years for firms that provide audit reports for at least one, but no more than 100 issuers. Section 4 of the Rules of the Board establishes the basic framework for the PCAOB's inspection process, including reporting the results of inspections, notifying the Securities and Exchange Commission regarding possible violations of the Act or other requirements, and communicating with the registered firms regarding the results of inspection.

Board Rule 4000 assigns responsibility for inspections "steps and procedures" to the Division of Registration and Inspections. The division is led by a Director and includes a Washington, DC office and regional offices in Atlanta, Chicago, Dallas, Denver, New York, and Orange County and San Francisco, California. As of October 2005, the division included 190 regular employees, of whom 169 were considered to be directly involved with inspections. The division also used four consultants to assist with inspections-related work.

At the time of our review, the Division of Registration and Inspections was in the midst of its second cycle of full-scope inspections. In 2003, the division conducted "limited" inspections of the four largest accounting firms. The 2003 inspections were, by design, scaled down in scope as compared to the full-scale inspections to be conducted in succeeding years. The division inspected 99 firms in 2004 and, as of October 2005, had completed field work for 218 of the 284 (includes domestic and international firms) inspections planned for 2005.

As with our previous reviews in this internal control series, Internal Oversight and Performance Assurance is mindful that the PCAOB is a blend of organizational cultures that was established as a private sector entity yet charged with a public interest mission. The Board has articulated its intent to use innovative and cost-effective tools to improve audit quality, strengthen competition in the accounting profession, reduce the risks of financial reporting and auditing failures, and restore public trust in the financial reporting process and accounting profession.

In our judgment, successful implementation of these goals is also dependent on the continuing establishment of robust internal standards, policies, procedures, and

## **PERFORMANCE REVIEW**

professional practices to guide PCAOB operations, including inspections, on a day-to-day basis. Board members have noted, in particular, that the inspections function is central to the PCAOB's success. For purposes of this review, we generally use the term "internal control" as defined by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission, reproduced below.

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.<sup>2/</sup> COSO's broad-based view of internal controls is consistent with Internal Oversight and Performance Assurance's charter to help ensure the efficiency, effectiveness, and integrity of PCAOB programs and operations.

### **Results of Review**

Internal Oversight and Performance Assurance examined documentation concerning a range of policy and procedures for conducting and reporting on inspections, as well as such administrative matters as scheduling, training, and performance management. We also discussed aspects of the inspections process with the Director of Registration and Inspections and more than 60 other division employees.

---

<sup>2/</sup> In addition, the review was not designed to provide an assessment of quality assurance over inspections reports or documentation. IOPA provided separate quality assurance comments to the Director of Registration and Inspections.

## **PERFORMANCE REVIEW**

Based on our review, we concluded that the division has significant infrastructure in place to guide and communicate the "steps and procedures" required to conduct inspections. We observed an array of guidance covering both large and small firm inspections, and noted that the division has mechanisms in place to continually review and update its processes. In fact, some of the guidance we examined had already been substantially revised to reflect lessons learned in the initial inspections cycles. Although much of the information we reviewed is still in draft form, inspectors told us, generally, that division leaders have communicated expectations regarding the conduct of inspections.

With regard to the ongoing development of internal standards, practices, and controls, we specifically noted that the Division of Registration and Inspections –

- Reengineered, for 2005, its approach to small firm (100 or fewer issuer clients) inspections. Aspects of the revised approach included smaller inspection teams; inspection of fewer audit engagements; an enhanced focus on high-risk engagements; and the performance of some inspections in PCAOB offices rather than at firm sites, an initiative intended to save time and expense associated with travel. The revised approach also assigned to regional offices a portion of the responsibility for inspection scheduling, coordination, quality control, and report review.
- Developed, consistent with its redefined approach to small firms, a small firm inspection manual. The manual provides an overview description of the small firm inspection process from such "preplanning" activities as firm selection and assignment of staff, to report writing and organization of supporting documentation. Subsequent manual chapters provide inspectors with information and guidance on attributes of small firms, planning and conducting the inspection, and documenting the results in a systematic and consistent manner. At the time of our review the manual was in draft and the division planned to add additional chapters on reporting and preparing comment forms. Even so, however, the vast majority of inspectors expressed the view that the draft manual represented a major improvement over guidance available in 2004.
- Developed, beginning in 2003 and continuing to the present, more than 50 guides for use by inspectors as they plan and conduct inspections of the largest eight accounting firms. The guides cover such general areas as fraud, revenues, reserves, audit committee communications, income

## **PERFORMANCE REVIEW**

taxes, and going concern issues, as well as a number of more specialized subjects. In general, the guides outline relevant inspection objectives, provide references to professional accounting literature, and include a series of questions to help the inspector evaluate the audit.

- Drafted guidance for the PCAOB's inspections, conducted for the first time in 2005, of audits of internal control over financial reporting ("ICFR"). The draft guidance included, among other materials, discussion of the division's overall approach, policy, and processes regarding ICFR inspections, frameworks for evaluating controls, and ICFR-specific inspection guides.
- Developed and conducted extensive technical accounting and inspections-specific training sessions over the past three years. As part of this process, the division gained approval from the National Association of State Boards of Accountancy to offer continuing professional education for certified public accountants. In addition, the division had drafted a continuing professional education policy and, in August 2005, initiated a new inspector training class.
- Deployed a nationwide scheduling process and system designed to help the division meet its statute-defined requirements for conducting inspections as efficiently and effectively as possible. At the time of our review, the division was working with information technology staff to upgrade the system's technology to improve data integrity and overall functionality.
- Undertook a variety of projects to develop, update, or improve various programs and processes, including large and small firm inspections, large issuer inspections, shell companies, audit methodology, training, and career path. Some of these projects are ongoing, while others have been suspended pending completion of the 2005 inspections.

During our review we also made a number of observations for division leaders to consider as they continue to develop and enhance the infrastructure supporting the inspections process. We noted, for example, that opportunities existed to –

## **PERFORMANCE REVIEW**

- Apply some of the lessons learned in reengineering the small firm process to other aspects of the inspections program, including inspection of the largest eight firms.
- Clarify requirements regarding the application of the PCAOB's document retention policy as it relates to inspections.
- Improve the organization and accessibility of existing guidance.
- Communicate the division's overall training strategy and approach.
- Work with information technology to ensure that decisions regarding upgrades to the scheduling system are based on a documented analysis of costs and benefits.

IOPA provided details supporting these observations to the division in a draft report in October 2005. The Director, Division of Registration and Inspections provided comments on the draft in which he described a number of program enhancements the division intends to implement. For example, division leaders intend to create a manual for the conduct of large firm inspections that will be available for reference prior to the commencement of the 2006 inspections. The Director's comments also indicated that the division will work with the Office of General Counsel to prepare additional guidance regarding the Board's interim document retention policy, which it will issue in written form to the inspections staff. Other division initiatives include preparing a master inventory of all inspections guidance and information on scheduling, reporting, and related topics. Division leadership also plans to distribute training policy and planning documents, along with other periodic communications, to all inspectors. In addition, the Director's comments indicated a commitment to working with other Board offices to ensure appropriate information technology solutions and enhancements.

The Director's comments were prompt and responsive to the themes discussed in our report.