



VIA ELECTRONIC FILING AND HAND-DELIVERY

August 18, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

**PCAOB Rulemaking Docket Matter No. 006,
Proposed Rules on Inspections of Registered Public Accounting Firms**

Dear Sir or Madam:

Ernst & Young is pleased to submit these comments on the Public Company Accounting Oversight Board's proposed rules regarding the inspection registered public accounting firms.

The inspection process is a fundamental component of the PCAOB's mission. We believe that the PCAOB's rule proposals largely reflect the requirements set forth in the Sarbanes-Oxley Act ("the Act") and will provide for fair and meaningful inspections. It is in our best interest, as the auditor of more than 2500 public companies in the United States, to make sure that all aspects of our auditing and quality control processes are the highest quality possible. We expect that the PCAOB's inspections will assist us in finding areas where we can improve our performance.

We do, however, have comments on several elements of the rule proposals. They are set forth below.

1. **Proposed Rule 4000 (General):** The proposal states that inspections shall be performed by PCAOB staff "and by such other persons as the Board may authorize to participate in particular inspections or categories of inspections." The employment status of these "other persons" is not described. In view of the confidentiality of documents and other information that will be available to the inspection team, the PCAOB should make clear that any outside contractors employed by the PCAOB will be subject to the confidentiality requirements applicable to PCAOB members and staff.
2. **Proposed Rule 4002 (Special Inspections):** Consistent with Section 104(b)(2) of the Act, the proposed rules provide for "special inspections" of registered firms. The proposing release (at page 7) states that such inspections may be prompted by "information that comes to the attention of the Board or its staff in any way, including public company filings with the Commission, news reports and matters brought

informally to the attention of the Board's staff by other regulators, professional associations, informants, and members of the public."

We are concerned about the open-ended nature of the "special inspection" procedure and the lack of clear dividing lines between such inspections and Board informal investigations, which will be governed by a separate, and much more detailed, set of rules (*see* Proposed Rules on Investigations and Adjudications, PCAOB Rulemaking Docket Matter No. 005). The Board should make clear that special inspections 1) are not intended to supplant the Board's investigative rules and procedures, and 2) are designed to address systemic issues relating to a firm's quality control or auditing procedures rather than individual audit failures or other client-specific matters.

- 3. Proposed Rule 4004 (Procedures Regarding Possible Violations):** Section 104(c) of the Act provides that if the Board identifies a possible violation of a rule or a professional standard during an inspection the Board shall report that finding "to the Commission and each appropriate State regulatory authority." The rule text essentially tracks the proposed rule. However, in the rulemaking release (at page 8) and in a note to Rule 4004 the Board states that it intends to make referrals to persons "other than those specifically described in Rule 4004," such as the broader range of persons identified in Section 105(b)(5)(B), relating to violations that are found during investigations – that is, the Department of Justice, federal banking agencies, state attorneys general, and any appropriate State regulatory authority. Because Congress clearly specified a different set of entities to whom referrals might properly be made after inspections and investigations, it seems inappropriate for the Board to adopt the broader list in Section 105(b)(5)(B) and likewise to state that it might provide information about possible violations to persons "other than those specifically described in Rule 4004." Presumably, and quite reasonably, Congress believed that routine inspections should not expose registered firms to as large an array of possible collateral proceedings as those appropriate for violations discovered during investigations.

In addition, we urge the Board to make clear that it will not refer any "possible violation" to the Commission and other authorities. That is a low threshold. We would expect that significant possible violations might properly be referred to the Board's investigative staff, and then perhaps to the Commission and other authorities if unusual circumstances warrant such additional regulatory involvement. The "possible violation" threshold is particularly troublesome if the Board were to leave unchanged the open-ended nature of the referral process described in the preceding paragraph.

Finally, we suggest that the Board establish a procedure where it would notify the firm whenever it intends to refer a possible violation to the SEC. It would also be helpful in our view for the Board to establish a procedure where the firm is given an opportunity to discuss the matter with the Board's staff – perhaps even to allow Wells-type submissions – prior to referral to the Commission.

- 4. Proposed Rule 4006 (Duty to Cooperate with Inspectors):** The proposal would require a registered accounting firm to provide "any" documents or other information that "may be requested by the Board's inspectors and that the Board considers relevant or

material to the subject matter of the inspection.” This is a very broad provision. It suggests, for example, that even though the inspection process is intended to determine the registered firm’s compliance with rules and standards with respect to *issuers* or *U.S. public companies* (see, e.g., rule release, pages 1 and 2), the Board might request information relating to audits of non-issuers if such information might be “relevant” to the Board’s inspection. We urge the Board to clarify, consistent with the standard established under Section 104(a) of the Act, that materials “relevant or material” to the subject matter of an inspection would, by definition, specifically relate to a registered public accounting firm’s compliance with the Act, Board or SEC rules, or applicable professional standards relating to the firm’s performance of audits, issuance of audit reports, or related matters involving issuers.

In addition, certain sensible limitations should be imposed on the types of information that are subject to inspection. For example, the PCAOB’s final rule release should make clear that the Board does not interpret the Act as having abrogated the attorney-client or other privileges, and that attorney-client communications and attorney work-product documents are not subject to inspection. Personal information, such as partners’ or employee’s medical records, also should not be subject to inspection.

5. **Proposed Rule 4007 (Procedures for Firm Review of and Response to Draft Inspection Report and Issuance of Final Inspection Report):** We have three comments this rule proposal.

First, it would appear that the Board intends to issue separate reports for regular and special inspections, but this should be clarified.

Second, paragraph (c) of the proposal allows the inspected firm to comment on a draft report but states only that the Board “in its discretion” may give the inspected firm an opportunity to comment on a revised draft prior to the Board’s issuance of a final report. We believe that the firm should be allowed to respond to the revised draft report to the extent significant changes have been made in it. This is particularly appropriate because the rule release states (at page 8) that “[t]he firm’s response to the draft inspection report shall be attached to and made part of the inspection report” – if significant changes have been made from the initial draft, then the firm’s comment letter should respond to the revised draft as well as to the final inspection report if different from the revised draft. We further note that the rule text itself (as opposed to the rule release) does not state that the firm’s response to the report will be attached to the final report; the Board should include a description of that process in the rule text.

Third, the proposal should make clear that draft reports and responses to those reports, as well as related documents, are within the scope of the confidentiality/privilege protections of Section 105(b)(5)(A) of the Act because, as that provision sets forth, they are documents “prepared . . . [and] received by . . . the Board” and are “prepared . . . specifically for the Board” in connection with a Board inspection.

6. **Proposed Rule 4008 (Transmittal of Final Inspection Report):** The proposal provides that the final report will be sent to the inspected firm, the Commission, and state

regulators. The proposal further states that “the report may be accompanied by any additional letter or comments by the Board or the Board’s inspector that the Board deems appropriate.” We are concerned that this procedure could circumvent the procedures required by the Act and set forth in Rule 4007 by which the inspected firm will have the opportunity to respond to matters being reported by the Board. Substantive issues relating to the inspection should be addressed in the report itself, not in the transmittal letter. Alternatively, the inspected firm should be given an opportunity to review and comment on such letters before they are finalized.

In addition, the proposed rule seems to provide for broader dissemination of the inspection reports than is required by the Act. The proposal states that the Board will issue inspection reports “in appropriate detail, to each state, agency, board or other authority that has issued a license or certification number authorizing the firm to engage in the business of auditing or accounting.” By contrast, Section 104(g)(1) of the Act only provides for disclosure to “each appropriate State regulatory authority,” which Section 2(a)(1) of the Act defines as “the State agency or other authority responsible for the licensure or other regulation of the practice of accounting in the State or States having jurisdiction over a registered public accounting firm . . . with respect to the matter in question.” It seems doubtful that a regulatory agency in, for example, New Mexico has “jurisdiction over a registered public accounting firm . . . with respect to” conduct that occurs in and affects a company in, for example, Pennsylvania. Although perhaps implicitly addressed by the proviso that the states need only receive copies of inspection reports “in appropriate detail,” the proposed rule should be revised explicitly to reflect that copies of inspection reports will not be sent to states which have no significant regulatory interest over the matter addressed in the report.

7. **Proposed Rule 4009 (Firm Response to Quality Control Defects):** This rule provides the procedure for firms to provide to the Board evidence of improvements made in response to criticisms or defects found by the Board during the inspection. It states that, after reviewing such evidence, the Director of the Division of Registration and Inspections shall advise the firm of his or her conclusion as to whether the firm has satisfactorily addressed the criticisms or defects; that he or she will make a recommendation to the Board in this regard; and that the Board will then notify the firm of its final determination. As proposed, this procedure does not provide for any input from the firm. We believe that we should be able to respond formally whenever the Director determines that we have not satisfactorily addressed criticisms or defects identified in the inspection process.
8. **Additional issues:** We have several additional suggestions, which largely reflect our understanding of practices used by the SEC in its inspections of regulated entities.

First, routine inspections should not be commenced without prior notice, which should be provided at least three weeks prior to the commencement of the inspection. We also urge that the Board not conduct “surprise” inspections except in extraordinary circumstances. A firm should be given the opportunity to gather documents, set aside office space, ensure that relevant personnel are available, and otherwise prepare itself for the inspection. Providing such preparation time facilitates an efficient and thorough

inspection. The only reason for a surprise inspection of which we are aware is where there is concern that a firm might destroy or alter relevant documents. In view of the “death penalty” impact that such a course of action would have on an accounting firm and its personnel – potential criminal liability, loss of licenses, and so on – the Board need not realistically be concerned that any reputable accounting firm would engage in such illegal activity.

Second, the firm should have a right to request at least one postponement of a routine inspection for good cause.

Third, visits to satellite offices during the inspection should always be preceded by notice to the firm’s headquarters.

Fourth, all inspections should be completed within a set time.

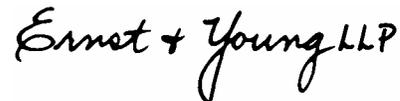
Fifth, the PCAOB should recognize that the firm being inspected has a right to have its legal counsel present during the inspection.

Sixth, a specific person at the PCAOB should be designated to resolve disputes that may arise during an inspection.

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We appreciate the opportunity to provide these comments, and we would welcome discussion of any points that require further explanation.

Respectfully submitted,

A handwritten signature in black ink that reads "Ernst & Young LLP". The signature is written in a cursive, flowing style.

Ernst & Young LLP