

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 210 and 229

[Release Nos. 33–8109; 34–46120; 35–27543; 1A–2039; 1C–25624; File No. S7–24–02]

RIN 3235–AI41

### Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (“SEC” or “Commission”) is proposing rules designed to restore investors’ faith in the financial information that they rely on for their investment decisions. The proposed rules reform oversight and improve accountability of auditors of public companies, thereby enhancing the reliability and integrity of the auditing and financial reporting processes. Under the proposed rules, a registrant’s financial statements will not comply with the requirements of the securities laws and Commission rules and regulations thereunder unless the registrant’s independent accountant is a member of a Public Accountability Board (“PAB”), and the registrant engaging the accountant to audit or review financial statements or prepare attestation reports that are filed with the Commission is an adjunct member of the same PAB to which the accountant belongs.

To improve oversight of and investor confidence in the quality of financial reports filed with the Commission, the Commission will not recognize a PAB unless the PAB meets certain conditions and performs certain functions. A PAB must have a Board that is dominated by persons who are not members of the accounting profession and must be subject to the Commission’s oversight. A PAB must be committed to improving the quality of financial statements relied on by investors and the professional conduct of accountants by, among other things, directing periodic reviews of accounting firms’ quality controls over their accounting and auditing practices and, when appropriate, disciplining accountants. A PAB also would set, or rely on and oversee designated private sector bodies to set, audit, quality control, and ethics standards. Disclosure would be required in Commission filings if an executive officer, director, or director nominee of a registrant has

been sanctioned as a member accountant by a PAB within the last five years and the sanction has not been reversed, suspended, or vacated.

**DATES:** Comments should be received on or before September 3, 2002.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following electronic mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7–24–02. This file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission’s Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission’s Internet website (<http://www.sec.gov>).<sup>1</sup>

**FOR FURTHER INFORMATION CONTACT:** Samuel L. Burke, Associate Chief Accountant, Bert W. Mehrer, Assistant Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant, at (202) 942–4400, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–1103.

**SUPPLEMENTARY INFORMATION:** We are proposing to amend rule 1–02<sup>2</sup> and rule 2–01<sup>3</sup> of Regulation S–X, add new rules 13–01 through 13–07 to Regulation S–X,<sup>4</sup> and amend item 401<sup>5</sup> of Regulation S–K.

### I. Executive Summary

Congress, through the federal securities laws, imposed on public companies the obligation to disclose complete and accurate financial information. Cognizant of the lessons of history, however, Congress built into the securities laws a significant safeguard: requirements that a public company’s financial information filed with the Commission be audited by certified or public accountants that are independent of that company.

The investing public and the Commission must rely on the competence, ethics, and independence of accountants who certify the financial statements of public companies. People

invest their savings in the securities of public companies and thereby make capital allocation decisions in reliance on the financial statements of those companies. If investors lack confidence in the reliability of the information presented, the fundamental purposes of the federal securities laws—to protect investors and promote efficient markets—are thwarted.

Effective oversight of the accounting profession is critical to quality financial information and trust in and reliance on that information. By having effective oversight, investors are assured that skilled, disinterested professionals operating under high ethical standards and strict quality control procedures are auditing financial statements. Strong oversight helps to strengthen audit practice and to detect and deter weaknesses that could detract from an accountant’s ability to fulfill the goal of having financial statements audited by competent, independent accountants. Further, when oversight is compromised, the quality of financial information can be affected, and investors’ trust in the quality of financial information is compromised as well.

The current system of oversight has not produced a credible result. Flaws in the system have contributed to the confluence of several factors that have undermined investor confidence in financial information and market efficiency.<sup>6</sup> Those factors include:

- The dramatic and sometimes sudden reversals of public companies’ financial conditions, with corresponding significant financial losses by investors and pensioners;
- Revelations of accounting irregularities at public companies, including large and seemingly well-regarded companies;
- The number of restatements of financial information by public companies;
- Increasing pressures on company management and auditors in today’s economic environment;
- Continuing concerns about the oversight of the accounting profession, including issues regarding the independence and effectiveness of the current peer review and disciplinary processes; and
- The ineffectiveness of the Public Oversight Board (“POB”) that had overseen the peer review system of public accountants.

<sup>1</sup> We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

<sup>2</sup> 17 CFR 210.1–02.

<sup>3</sup> 17 CFR 210.2–01.

<sup>4</sup> 17 CFR 210.13–01–13.07.

<sup>5</sup> 17 CFR 229.401.

<sup>6</sup> See, e.g., Matt Krantz and Greg Farrell, *Fuzzy accounting raises flags*, USA Today, June 22, 2001, at 1B (quoting an individual investor, “I almost don’t believe any numbers I read anymore”); Rebecca Byrne, *Audit Business Nearing Crisis of Faith*, TheStreet.com, Dec. 10, 2001.

These factors highlight longstanding deficiencies in the regulatory system used to oversee the quality of the audits and reviews of financial statements that are filed with the Commission and relied on by investors and the Commission. These factors, among others, have contributed to a consequent decline in investor confidence, and provide the impetus for the Commission's proposals.

We are proposing a new system of independent private sector regulation designed to improve oversight of the auditing process and strengthen investor confidence in financial information. The accounting profession would not and could not control or dominate the proposed system. Rather, instead of a body that functions under the aegis of the American Institute of Certified Public Accountants ("AICPA"), which represents the accounting profession, we propose to create a framework for a new independent, private sector body (or bodies) that we have termed a "Public Accountability Board" ("PAB").<sup>7</sup>

Among other things, a PAB would discipline accounting firms and individual accountants for unethical or incompetent conduct or other violations of professional standards. A PAB would also direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices. A PAB would supplement, not supplant, our enforcement efforts. We would continue vigorously to investigate and pursue instances of accounting misconduct. The new system would expand the opportunities to detect and remedy ethical lapses or deficiencies in competence, or violations of professional standards, thereby complementing our enforcement efforts.

Based on public input we have received to date, and our own experience, we have identified certain key elements of a new framework to improve oversight of the accounting profession. We believe that these elements will promote investor confidence in the financial reporting process.<sup>8</sup> The following elements, as

well as others discussed in more detail below, are the foundation of our proposals:

- **Private Sector System of Regulatory Oversight.** The accounting profession would be subject to a private sector system of regulatory oversight directed by representatives of investors and issuers, not self-regulation by the profession.

- **Requirements as to Financial Statements.** To assure that the benefits of the oversight process extend to investors in all public companies:

- An SEC registrant's financial statements would not comply with Commission requirements unless the registrant's accountants who audited or reviewed those statements were members of a PAB; and

- An SEC registrant's financial statements would not comply with Commission requirements unless the registrant were a member of, and thereby bound to cooperate in any review or proceeding commenced by, the same PAB as its accountants.<sup>9</sup>

- **Independent Board.** To ensure independence from the accounting profession that it would oversee, a PAB would be a diverse board, dominated by persons who are not associated with the accounting profession.

- **Independent and Dependable Funding Source.** To assure continuity and independence, a PAB would have a dependable, uninterrupted funding source and not be voluntarily or solely funded by members of the accounting profession. A PAB's operations would be funded through the assessment of fees on accounting firms who are members of the PAB and on the audit clients of those firms—a funding mechanism that is not controlled by the accounting profession.

- **SEC Oversight.** Because a PAB would serve an important public function, a private entity could not serve as a PAB unless it was recognized by the Commission after Commission review of, among other things, the entity's proposed structure, its charter, by-laws, budget, and proposed board members. Conditions of a PAB's

recognition by the Commission would include a PAB's irrevocable consent to the continuous oversight function by the Commission.

- **Cooperation with a PAB.** To remain in "good standing," accounting firms, individual accountants, companies, and companies' management would cooperate with PAB quality control reviews, supplemental reviews, and disciplinary proceedings.

- **PAB Quality Control Reviews.** A PAB would perform quality control reviews of audit procedures and practices. To maintain high standards of auditing, ethics, and quality control among its members, a PAB would perform periodic quality control reviews of its member accounting firms. In conducting reviews, a PAB would ensure that accounting firms have quality control policies and procedures regarding, among other things: (i) independence, integrity, and objectivity; (ii) personnel management; (iii) acceptance and continuation of clients; (iv) audit performance; (v) audit methodology; and (vi) consultation and resolution of differences of professional opinion. A PAB would perform annual reviews of large accounting firms.

- **PAB Disciplinary Powers.** A PAB would conduct public disciplinary proceedings and would have the ability to discipline accountants for unethical or incompetent conduct or other violations of professional standards. A PAB would be able to impose a wide range of disciplinary or remedial sanctions, including:

- Fines;
- Censures;
- Required remediation;
- Removal of an individual or termination of a firm from an audit engagement;
- Limitations on certain activities; and
- Suspension or disbarment from membership in a PAB.

- **Audit Standard Setting.** A PAB should have responsibility for assuring high standards of ethics, auditing, and quality controls for its members. A PAB should either set such standards or oversee any private sector bodies designated to set standards.

<sup>7</sup> Under our proposals, more than one PAB could be formed. For purposes of this release, however, we will refer to PABs in the singular.

<sup>8</sup> See, e.g., Transcripts from the public Roundtables that the Commission sponsored on *Assuring Adequate Oversight of Auditing Function* held on March 4, and 6 and April 4, 2002, in New York, Washington, DC and Chicago, respectively ("SEC Roundtables"). Transcripts of the SEC Roundtables are available through the Commission's web site: [www.sec.gov](http://www.sec.gov). Participants included: On March 4, Robert Mundheim (moderator), William Allen, Warren Buffet, James Copeland, David Shedlarz, Melvyn Weiss; on March

6, Judge Stanley Sporkin (Ret.) (moderator), Robert Glauber, Neil Lerner, Professor Jonathan Macey, Ted White; on April 4, J. Carter Beese, Jr. (moderator), Ken Bertsch, Davis Costello, Professor Dan Fischel, Barbara Franklin, and Edward Nusbaum. The Commission also held an Investor Summit ("Investor Summit") at which it received valuable input. The webcast of the Investor Summit is available at [www.connective.com/events/secsummits/](http://www.connective.com/events/secsummits/).

<sup>9</sup> As we discuss in detail below, a PAB will require a registrant's cooperation only to the extent necessary to further a PAB's reviews or proceedings regarding the registrant's accountant. A PAB will not conduct "roving" investigation of registrants and will not sanction registrants.

## II. The Pressing Need To Improve Oversight of, and Restore Confidence in, the Auditing and Financial Reporting Processes

### *A. The Federal Securities Laws Contemplate, and Their Effective Application Depends Upon, the Existence of Mechanisms for Adequate Oversight of the Auditing Component of the Financial Disclosure Process*

It is no mystery what problem Congress intended to remedy—and believed it was remedying—by seeking to insure that issuers provide investors with “complete information relative to the financial condition of the issuer.”<sup>10</sup> As the Senate Report on the Securities Exchange Act of 1934 (“Exchange Act”) described:

The committee has repeatedly heard testimony illustrating the evasions, suppressions, distortions, exaggerations, and outright misrepresentations practiced by corporations with intent to cloak their operations and to present to the investing public a false or misleading appearance as to financial condition. The chairman of the committee on stock list of the New York Stock Exchange testified that \* \* \* [in one case] practically all the assets of the company consisted of notes receivable, good will, and licenses arbitrarily valued at grossly exaggerated figures. The testimony also established that within a period of a few days the assets of the company were written up 100 percent in value. In another case brought to the attention of the committee, the assets of a company were marked up from \$4,000,000 to \$24,000,000. A memorandum prepared by a corporate official was introduced in evidence which discussed the alternatives of preparing the corporation’s annual report in either the ‘standard’ or the ‘understandable’ form, the decision being in favor of the former. Many other instances of ‘window dressing’ were observed, where inexcusable methods were employed to inflate assets, obscure liabilities, and conceal deficits.<sup>11</sup>

We begin from the premise that, through the securities laws’ requirements related to financial disclosure, Congress intended to address these issues directly and forcefully. Congress did so by prescribing certain general statutory requirements and delegating to the Commission the regulatory flexibility to implement those requirements and to adopt regulations in furtherance of the statutes’ purposes.

Those statutory prescriptions include requirements that public companies’ financial information filed with us be certified by independent public or

certified public accountants.<sup>12</sup> Without an unqualified audit opinion from an accounting firm,<sup>13</sup> a Commission registrant or issuer in an initial public offering has not satisfied and cannot satisfy the statutory and regulatory requirements for audited financial statements, its filings are deficient under the securities laws, and it cannot sell securities to the public or file its annual reports in conformity with Commission rules. Furthermore, without an accounting firm’s review of a registrant’s quarterly financial statements,<sup>14</sup> a registrant cannot not file its quarterly reports in conformity with Commission rules.<sup>15</sup> Accounting firms also must prepare attestation reports related to the internal controls of certain broker dealers,<sup>16</sup> investment companies,<sup>17</sup> transfer agents,<sup>18</sup> and others.<sup>19</sup>

Under the statutory scheme, accountants are the only professionals

<sup>12</sup> For example, Items 25 and 26 of Schedule A to the Securities Act of 1933 (“Securities Act”), 15 U.S.C. 77aa(25) and (26), and Section 17(e) of the Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. 78q(e), expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l(b) and 78m(a)(2), Sections 5(b)(2)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935 (“PUHCA”), 15 U.S.C. 79e(b), 79j(a)(1)(G), and 79n, Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 (“ICA”), 15 U.S.C. 80a–8(b)(5) and 80a–29, and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 (“Advisers Act”), 15 U.S.C. 80b–3(c)(1)(D), authorize the Commission to require the filing of financial statements that have been audited by independent public accountants.

<sup>13</sup> “An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.” AICPA, *Statements on Auditing Standards (“SAS”) No. 58, Codification of Statements on Auditing Standards (“AU”) § 508.10.*

<sup>14</sup> The proposed rules would define “review” in this context to mean a review of financial statements in accordance with generally accepted auditing standards (“GAAS”), as may be modified or supplemented by the Commission. A review includes procedures that are less in scope than an audit, and consists generally of inquiries and analytical procedures, rather than research and verification procedures. *See*, SAS No. 71, AU § 722 (as revised by SAS No. 90).

<sup>15</sup> Rule 10–01(d) of Regulation S–X, 17 CFR 210.10–01(d), which states in part, “Prior to filing, interim financial statements included in quarterly reports on Form 10–Q (17 CFR 249.308(a)) must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission.”

<sup>16</sup> 17 CFR 240.17a–5(g), (h), and (j).

<sup>17</sup> Form N–SAR, item 77B; 17 CFR 274.101.

<sup>18</sup> 17 CFR 240.17Ad–13.

<sup>19</sup> *See, e.g.*, Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980) regarding clearing agencies and Exchange Act Release No. 24216 (Mar. 13, 1987), 52 FR 8998 (Mar. 20, 1987) regarding depository trust companies.

that Commission registrants and issuers *must* engage before making a public offering of or having a public market for their securities. That alone is a significant indication of legislative intent concerning the critical role of the auditing process, but Congress did not stop by describing the required professionals merely as “accountants.” Rather, the securities laws qualify that term so that accountants auditing the financial statements of public companies are both subject to oversight intended to facilitate a high level of competence—reflected in the statutory requirement to be “certified public” or “public”—and disinterested in any outcome of the audit process other than getting reliable information to the public—reflected in the statutory requirement to be “independent.”<sup>20</sup> The securities laws supplement those safeguards by giving the Commission significant flexibility to make rules and regulations bearing on public companies’ financial disclosures, including the methods and forms employed in making those disclosures.

The Commission relies on certified financial statements, and consequently on the competence, ethics, and independence of accountants, to protect its processes and carry out its mandate.<sup>21</sup> While our staff reads and

<sup>20</sup> The Supreme Court has recognized and underscored the significant and unique role in which the securities laws cast accountants that audit public companies. In declining to extend to accounting firms certain confidentiality protections available to attorneys representing a client and preparing for trial, the Court emphasized that:

[a]n independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client \* \* \* [and] owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public.

*United States v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984). The Court further noted that, pursuant to the securities laws, “The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation’s industries.” *Id.* at 819 n.15.

<sup>21</sup> In this regard, the Commission adopted Rule 102(e) of our Rules of Practice to protect the integrity of Commission processes. 17 CFR 201.102(e). *See, e.g., Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979) (upholding the predecessor to Rule 102(e) as “reasonably related” to the purposes of the securities laws, in part because the rule “provides the Commission with the means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence”).

To protect its own processes, and by extension the investing public, the Commission vigorously pursues violations of professional standards. We have initiated Rule 102(e) proceedings when auditors failed to adhere to professional standards.

<sup>10</sup> S. Rep. No. 73–792, 1934 WL 1289 at \*10 (Apr. 17, 1934) (Senate Report on Securities Exchange Act of 1934).

<sup>11</sup> *Id.* at 11.

comments on a great many filings, it does not, cannot, and should not perform the extensive audit or review procedures that auditors must perform under GAAS. In addition, the volume of financial information filed with us far exceeds what the Commission staff can meaningfully review. We, therefore, must rely heavily on the accounting profession, as Congress intended, to ensure and enhance the integrity of the large volume of financial information that forms the cornerstone of our full disclosure system.<sup>22</sup>

In sum, investors and the Commission rely on accountants to assure disclosure of accurate and reliable financial information. As a result, "[b]reaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors."<sup>23</sup> Effective oversight of the accounting profession therefore is critical to protecting the public interest and preventing this "great damage" to investors.

We are concerned that we are today facing some of the same problems that Congress sought to address in the 1930s when the federal securities laws were enacted. Certainly there is evidence of a public perception that these problems are recurring with disconcerting, and unacceptable, frequency.<sup>24</sup> It falls to the Commission to try to identify the causes of the problem, and, to the extent possible, craft solutions consistent with its statutory mandate.

We have carefully considered the causes. For the reasons described below, we believe that the oversight mechanism for insuring that public companies have their financial statements audited by skilled, disinterested professionals operating under high ethical standards and strict quality control procedures is not working as intended. We are concerned that the deficiencies in that mechanism frustrate the financial disclosure purpose of the securities laws, undermine investor confidence in financial disclosures, and contribute to

inefficient capital allocation in the markets.

#### *B. Current Oversight Mechanisms Do Not Meet Their Objectives*

Several factors lead us to consider whether the accounting profession's self-regulatory oversight mechanisms, on which the markets and we have previously been willing to rely, do not meet the necessary objectives. For the reasons described below, we conclude that the self-regulatory mechanisms are not producing credible results, and that this failure may be linked to features that cannot realistically be expected to change through further self-regulation or minor changes to the current oversight mechanism.

The factors that concern us include the recent increases in the number of public companies restating their financials, revelations of serious financial difficulties at a variety of companies, a closed-door professional disciplinary process, and serious questions related to the current system of firm-on-firm "peer reviews" as a check on accountants' quality control processes.<sup>25</sup> The need for significant structural reforms in the oversight process to protect the public has been suggested by several people.<sup>26</sup>

As noted, one indication of the need for an enhanced regulatory structure is the increase in the number of restatements in recent years. According to a recent study, in the last three years more than 700 companies have restated earnings.<sup>27</sup> While there are many reasons for these restatements, we are concerned that they contribute to investor confusion and weaken investor

confidence in the financial reporting process.

Through the 1990s, such restatements, as well as allegations of accounting irregularities at companies such as Miniscribe and Phar-Mor, and more recently at companies such as Rite-Aid, Cendant, MicroStrategy, Sunbeam, McKesson HBOC, Waste Management, and Xerox have caused increasing concern. The bankruptcy of Enron Corporation last year, which was the largest bankruptcy in history and resulted in substantial financial losses to investors and pensioners, has dramatically heightened the public attention given to those concerns, posing a critical threat to investor confidence in financial information generally.<sup>28</sup>

To the extent that restatements and accounting irregularities suggest a failure of those in the accounting profession to perform consistently with sufficient skill and competence,<sup>29</sup> we are concerned that inherent limitations in the existing oversight mechanism prevent that mechanism from doing all that is required to curb such lapses. For example, the existing self-regulatory mechanism has not through its system of peer review uncovered significant deficiencies in competence, and it does not, and probably cannot, include the power to suspend incompetent individuals altogether from providing audit, review, or attest services to public companies.

While some aspects of the existing system are plainly beneficial, including, for example some portions of the Quality Control Inquiry Committee ("QCIC") process,<sup>30</sup> the profession's

For example, we sanctioned auditors under Rule 102(e) for not appropriately responding to warning signals pointing to client fraud (see, e.g., *In the Matter of Nanette Miller*, Accounting and Auditing Enforcement Release No. ("AAER") 1241 (Mar. 29, 2000); *In the Matter of Laubscher and Griffin*, AAER 1082 (Sept. 29, 1998)), and when they have failed to obtain the specialized knowledge necessary to perform an audit (see, e.g., *In the Matter of Ruzicka*, AAER 1155 (Aug. 24, 1999)).

<sup>22</sup> The courts have recognized this regulatory regime. *Touche Ross*, 609 F.2d at 581.

<sup>23</sup> *Id.*

<sup>24</sup> See, e.g., Nanette Byrnes, *Accounting Failures Aren't New—Just More Frequent*, Bus. Wk., Jan. 28, 2002, at 46.

<sup>25</sup> During the initial stages of the Commission's consideration of these issues, the profession's vehicle for oversight of the peer review system was the POB, until it voted to disband, and as of April 30, 2002, ceased official operations. The AICPA's SEC Practice Section (for firms that audit financial statements filed with the Commission) ("SECPS") has indicated that, notwithstanding the POB's decision to terminate operations, the SECPS will continue its peer review and QCIC programs until such time as a new regulatory model replaces them. The SECPS also has indicated that it will continue to fund the oversight operations of the POB staff (now called the Transition Oversight Staff, or TOS) during this transition period. Letter from Robert J. Kueppers, Chair, to Robert K. Herdman, Chief Accountant (Feb. 15, 2002). See also SEC Press Release No. 2002-40 (Mar. 19, 2002) regarding the TOS's continuing review of certain accounting firms' quality control systems for assuring compliance with auditor independence requirements.

<sup>26</sup> See generally Section II.C. below.

<sup>27</sup> One recent study identified 234 restatements in 1999, 258 restatements in 2000, and 305 restatements in 2001. Huron Consulting Group, *A Study of Restatement Matters: For the Five Years Ended December 31, 2001*, at 8 (June 11, 2002). See also Jim McTague, *Fixable Flaws*, Barron's, Jan. 7, 2002, at 16.

<sup>28</sup> During the 1990s, federal banking regulators reviewed the performance of accounting firms in relation to the savings and loan crisis of the late 1980s and early 1990s. Accounting firms' settlements of actions pending before the Office of Thrift Supervision included, among other things, increased training requirements for individuals working on audits of financial institutions, work paper retention requirements, additional consultation procedures within the firms, and the payment of significant restitution to the Federal Deposit Insurance Corporation and Resolution Trust Corporation. See *In the Matter of Ernst & Young*, OTS Order No. AP 92-127 (Nov. 23, 1992); *In the Matter of Deloitte & Touche*, OTS Order No. AP 94-13 (Mar. 14, 1994); *In the Matter of KPMG Peat Marwick*, OTS Order No. AP 94-37 (Aug. 9, 1994); *In the Matter of Grant Thornton, L.L.P.*, OTS Order No. AP 96-30 (Oct. 3, 1996).

<sup>29</sup> See Janet Whitman, *For Competence, Accounting Gets "D" in New Poll*, Wall St. J., Apr. 10, 2002, at A7; *Accounting Faces Crisis of Competence, Not Integrity*; "Andersen-itis" Isn't What Ails the Industry, Newstream.com, Apr. 10, 2002 (surveyed companies indicated accountants lack competence in certain technical areas).

<sup>30</sup> Under the membership requirements of the SECPS, after receiving service of a complaint in any litigation against the firm or its personnel, or the

ability to discipline or remedy incompetent or unethical conduct has been a persistent concern.<sup>31</sup> The profession's disciplinary program continues to suffer from several inherent weaknesses, including:

- *Peer reviews may not consistently be as thorough as necessary.* Peer review is the process by which other accountants assess and test compliance with quality control systems for the accounting and auditing practices of SEC Practice Section ("SECPS") members. The objectives of peer review are to determine whether the reviewed firm: (i) designed its system to meet Quality Control Standards established by the AICPA; (ii) complied with its quality control system to provide reasonable assurance of complying with professional standards; and (iii) complied with SECPS membership requirements. Upon the completion of a review the peer reviewer prepares a report and a letter of comments, which may recommend improvements to the firm's system of compliance. On occasion, firms have received "clean" peer review reports despite well-publicized problems within a firm. For example, a report published by an independent consultant noted one firm had numerous violations of the auditor independence rules,<sup>32</sup> yet the next peer review report on the firm mentioned neither the need for improvements in the firm's quality controls in this area nor the efforts the reviewed firm had underway to make those improvements. Our staff has provided the POB with comments on peer reviews with the goal of improving the process and achieving more understandable communications

commencement of any publicly announced regulatory investigation, that alleges deficiencies in the conduct of an audit of the financial statements of a Commission registrant, the firm must not only review the engagement to evaluate the performance of senior personnel with respect to the specific issues contained in the complaint but also report the matter to the QCIC. SECPS, *Requirements of Members*, at k; SECPS, *Appendix M—Procedures in Connection with an Alleged Audit Failure*, SECPS § 1000.46. The QCIC will review the matter and, if appropriate, refer it to the AICPA Professional Ethics Division, which will evaluate whether the matter warrants investigation.

<sup>31</sup> See, e.g., David S. Hilzenrath, *Auditors Face Scant Discipline*, Wash. Post, Dec. 6, 2001, at A01; See, e.g., John C. Burton, *The Evolutionary Revolution in Public Accounting*, 52 Brook. L. Rev. 1041, 1046-47 (1987) (Mr. Burton, former Chief Accountant to the SEC, commenting on the POB, has stated that "[w]hile the structure created was highly promising and the development of a regular process of peer review is very desirable, my own judgment is that the results have fallen short of expectations. In the first place, the emphasis on process and remedial actions has been too limiting. Peer reviews need to go beyond process to look at application of procedures and to develop a significant disciplinary process").

<sup>32</sup> See SEC Press Release No. 2000-4 (Jan. 6, 2000).

to the public of peer reviewers' findings.<sup>33</sup> For many years, we had stated in our Annual Report that the peer review and QCIC processes resulted in accounting firms "focusing on and achieving the important goal of maintaining and improving effective quality control systems."<sup>34</sup> Because of our growing concerns, however, we intentionally did not include that statement in our 1999, 2000, and 2001 Annual Reports.

- *The disciplinary process is voluntary.* The disciplinary program is conducted within the auspices of the AICPA, which is a voluntary private sector organization dominated by accounting firms.

- *There is no independent and dependable funding source.* During discussions about the POB's reviews of the firms' systems of quality controls over auditor independence, the SECPS took the unprecedented step of threatening to halt the funding for the POB's reviews.

- *The disciplinary process relies solely on information gathered from accountants.* The process is generally limited to reviewing information obtained from the accountants and does not include obtaining information from third parties, such as management of the audit client. As Norman R. Walker, former chairman of an AICPA disciplinary panel has said, "Basically we're confined to looking at the [public] record and the information that the [member] is able to provide and willing to provide."<sup>35</sup>

- *Sanctions are weak.* The most stringent sanction in an AICPA proceeding is expulsion from the AICPA, which does not directly affect an accountant's ability to practice before the Commission or elsewhere.<sup>36</sup>

- *The disciplinary proceedings are not public.* AICPA disciplinary proceedings are conducted behind closed doors and, while improvements have been made in the public reporting of sanctions, limited information is available regarding the results of its proceedings.

<sup>33</sup> See, e.g., SEC, *Annual Report 2001*, at 90; SEC, *Annual Report 1999*, at 91. The SEC staff oversees the peer review and QCIC processes by periodically selecting at random a sample of peer reviews and evaluating working papers and POB oversight files related to those reviews. Our staff also reviews QCIC closed case summaries and related POB oversight files.

<sup>34</sup> See, e.g., SEC, *Annual Report 1998*, at 74.

<sup>35</sup> David S. Hilzenrath, *Auditors Face Scant Discipline*, *supra* note 31.

<sup>36</sup> AICPA, *Official Releases: Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms*, J. Acct., Nov. 1977, at 113, 115.

### C. The Need for Reform Is Widely Recognized

Investor confidence in the quality of financial information is critical, and it is directly linked to investor confidence in the quality of audits.<sup>37</sup> As a participant in the Commission's Roundtables stated:

[T]he public should have real confidence that their interest is being looked after in the mechanism for regulating the profession, and disciplining the members of the profession, setting professional standards. All of those. They want to know that the way that this is done is going to look after their interests, and not just the interests of the body of the individuals who practice in that profession.<sup>38</sup>

Because of the above-described concerns, calls for improved oversight of the accounting profession have become more urgent.

Congress, the Commission, and many others have questioned whether weaknesses inherent in the profession's self-regulatory process limit its ability to improve sufficiently the performance of audits of public companies. More generally, strong public sentiment has emerged calling for more effective oversight. The connection between that oversight and investor confidence has never been as pronounced as it is today.

The need for reform has been highlighted by President George W. Bush. On March 7, President Bush announced a ten-point plan to improve corporate disclosure, make corporate officers accountable, and develop a stronger and more independent audit system. In discussing the latter point, President Bush stated:

An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards. Under this proposal, an independent regulatory board would be established, under the supervision of the SEC, to develop standards of professional conduct and competence. This board would have the ability to monitor, investigate, and where needed, enforce its

<sup>37</sup> See *Relationships Between Registrants and Independent Accountants*, Accounting Series Release No. 296 (Aug. 20, 1981), 46 FR 43181 (Aug. 27, 1981), which states in part:

[T]he capital formation process depends in large part on the confidence of investors in financial reporting. An investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest. The quality of information disseminated in the securities markets and the continuing conviction of individual investors that such information is reliable are thus key to the formation and effective allocation of capital. Accordingly, the audit function must be meaningfully performed and the accountant's independence not compromised.

<sup>38</sup> EC Roundtables, *supra* note 8, at 37 (Mar. 6, 2002) (statement of Neil Lerner, Head of Risk Management (U.K.), KPMG).

ethics principles by punishing individual offenders.<sup>39</sup>

In addition, the Commission recently held the SEC Roundtables to discuss a variety of issues relating to the financial reporting process, including auditor oversight and held an Investor Summit.<sup>40</sup> Participants in our Roundtables represented a variety of constituencies. Participants provided us with the benefit of extensive and diverse insights into the issues confronting the profession's self-regulatory programs and how those programs should be improved.<sup>41</sup> For example, Mr. Ken Bertsch, Director, Corporate Governance, at Teachers Insurance and Annuity Association College Retirement Equities Fund ("TIAA-CREF"), noted his organization's lack of confidence in the current peer review process. Others, such as Mr. David Shedlarz, Chief Financial Officer, Pfizer Inc., offered constructive outlines of the attributes and duties for a new regulatory body. While our proposals are not identical to any one participant's suggested approach, the discussions at the Roundtables were very valuable in helping us to identify issues, consider alternatives, and frame the positions contained in our proposed rules.

Beyond our Roundtables, others have voiced concerns with the current self-regulatory system and called for reform. For example, the Consumer Federation of America has called for a complete overhaul of the profession's self-regulatory system.<sup>42</sup> The Financial Executives International ("FEI") also has recommended the creation of a new oversight body for the accounting profession.<sup>43</sup> The FEI has indicated that a majority of the new oversight body's board should be executives with knowledge in accounting and finance, but should not be drawn from the audit profession. FEI further has stated that the new body's principal tasks should be oversight of audits and discipline.<sup>44</sup>

Many other observers and members of the accounting profession have lost confidence in the efficacy of the SECPS programs overseen by the POB and have

encouraged the development of a stronger body that plays a more active role in the oversight of quality control reviews and professional discipline. Former SEC Chairman Arthur Levitt also has called for a new oversight body. In his testimony before the Senate Committee on Governmental Affairs, he supported a "truly independent" non-governmental oversight body that has the power to conduct timely investigations and to discipline accountants. He also stated that the new body should operate in public—not behind closed doors—and, to preserve its integrity, the accounting profession should not fund the body.<sup>45</sup>

In addition, Harold Williams, who was the Chairman of the Commission at the time the SECPS and POB were created, stated in recent testimony before the Senate Committee on Banking, Housing, and Urban Affairs:

Self-regulation, aggressively overseen, can be much more effective in enforcing the spirit of the rules than can a policing agency of government. However, it is evident that the existing structure is not adequate to the task and needs to be redesigned and strengthened \* \* \*.

The Public Oversight Board was created by the profession during my chairmanship as an effort at self-regulation. We expressed concern at the time whether the peer review process administered by the profession would be adequate. But, as believers in the principle of self-regulation, we concluded that the Board should have the opportunity to prove itself. In my opinion, the events over the intervening years have demonstrated that it does not meet the needs and is not adequate \* \* \*. A system needs to be established which is independent of the accounting profession, transparent and able to serve both effective quality control and disciplinary functions.<sup>46</sup>

At the same hearing, former SEC Chairman David Ruder called for a new private sector regulatory system to oversee the accounting profession. In describing the deficiencies in the current system, he said:

[A]lthough the POB's powers have been strengthened, it does not have sufficient budget to allow it to function effectively. It does not have the power to force accounting firms to provide the documents necessary to complete investigations \* \* \*. It is forced to rely upon the accounting profession itself to engage in enforcement activities. Most

important, its connection to the AICPA creates an appearance of control by that body.<sup>47</sup>

Former SEC Chief Accountants and other leaders of the accounting profession also have stated publicly that a new regulatory body is needed.<sup>48</sup> Mr. James Turley, Chairman of Ernst & Young LLP, recently stated in an op-ed article in *The Wall Street Journal*:

[W]e should create a new regulatory body for the profession. It should have its own funding, offices and staff. It should have direct power over the profession's disciplinary and audit quality control programs, replacing the current "peer review" process in which firms review each other. To ensure maximum public credibility, this oversight should come from a body other than the American Institute of Certified Public Accountants, because many believe it has not maintained its historic focus on professional responsibility.<sup>49</sup>

Similarly, PricewaterhouseCoopers LLP, in letters to certain audit clients that are Commission registrants, stated, "[T]here is no question that the current regulatory structure is in need of reform."<sup>50</sup> It stated that changes that are especially critical include having oversight come from outside the accounting profession and involve more participative reviews by staff that is independent of the accounting firms. It

<sup>47</sup> *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, at 8 (Feb. 12, 2002) (statement of David S. Ruder, Chairman, Securities and Exchange Commission, 1987–89).

<sup>48</sup> *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight of the Accounting Profession, Audit Quality and Independence, and Formulation of Accounting Principles: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Feb. 26, 2002) (statement of Michael H. Sutton, Chief Accountant, Securities and Exchange Commission, 1995–98) which states: "Regulatory processes that will build confidence in the auditing profession will be truly independent; they will be open; they will actively engage, inform, and involve the public; they will be adequately resourced and empowered to accomplish their mission; and they will be amendable to change as events dictate. I believe that the critical ingredients of an effective regulatory process that can restore and maintain public trust include:

- Timely and thorough investigations of circumstances that may involve fraudulent financial reporting.
- Objective and fair assessments of the role and performance of the auditor.
- Timely and meaningful discipline of auditors and firms that violate acceptable norms of conduct.
- Regular oversight and periodic examinations of the policies and performance of independent auditors.
- Timely and responsive changes in professional standards and guidance when a need for improvements is identified."

<sup>49</sup> James S. Turley, *How Accounting Can Get Back Its Good Name*, *Wall St. J.*, Feb. 4, 2002, at A16.

<sup>50</sup> Letters from Samuel A. DiPiazza, Jr., Chief Executive Officer, PricewaterhouseCoopers LLP to selected audit clients (Jan. to Feb. 2002).

<sup>39</sup> Specifics on the President's Ten-Point Plan (Mar. 7, 2002) are available at <http://www.whitehouse.gov/news/releases/2002/03/20020307.html>.

<sup>40</sup> See *supra* note 8 regarding the SEC Roundtables and Investor Summit.

<sup>41</sup> *Id.*

<sup>42</sup> *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, at 6 (Mar. 20, 2002) (statement of Senator Howard M. Metzenbaum (Ret.), Chairman, Consumer Federation of America).

<sup>43</sup> FEI, *FEI Observations and Recommendations: Improving Financial Management, Financial Reporting and Corporate Governance* (Mar. 2002).

<sup>44</sup> *Id.* at 3.

<sup>45</sup> *The Fall of Enron: How Could It Have Happened?: Hearing Before the Senate Comm. on Governmental Affairs* (Jan. 24, 2002) (statement of Arthur Levitt, Chairman, Securities and Exchange Commission, 1993–2000).

<sup>46</sup> *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Feb. 12, 2002) (statement of The Honorable Harold M. Williams, Chairman, Securities and Exchange Commission, 1977–81).

also stated that the regulatory structure “needs teeth” and, “if an independent oversight body finds quality procedures lacking, it must have the right to revoke an individual’s or firm’s right to practice.”<sup>51</sup>

Congress has introduced several bills that would create bodies similar to, but in some respects different than, a PAB. Numerous committees in both the Senate and House have held hearings to explore reform of the accounting regulatory structure. A common theme in these hearings was the need for improvements in the manner in which accountants are regulated, and, in particular, the need for effective private-sector regulation of the accounting profession.<sup>52</sup>

We intend to continue to work with Congress on these and other bills, and will monitor the progress of pending legislation. We will implement any

legislation that is enacted. The Commission must proceed with its proposal under its existing statutory mandate, however, to strengthen investor confidence in the oversight of the auditing process and assure investors of comprehensive reform in the event that no legislation is passed.

#### *D. The History of Audit Oversight Mechanisms Suggests the Need for a Different Type of Oversight Mechanism*

Over the years the accounting profession has been subject to various forms of oversight with varying degrees of success. As a foundation for understanding the elements of the new oversight mechanism that we propose, we believe that it is useful to examine the history of the present system.

The current self-regulatory mechanism was developed as a result of concerns expressed during congressional hearings in the mid to late 1970s. These hearings investigated unexpected failures by major corporations and questioned why auditors failed to detect, and financial statements failed to reflect, illegal payments made by United States companies to foreign officials. During these hearings, the accounting profession’s competence to detect and deter such problems was a significant issue. The question was asked, “Where was the independent auditor?”<sup>53</sup> And bills were introduced that would have created a new regulatory structure for the profession.<sup>54</sup>

The hearings in the House of Representatives focused on how several federal agencies used the regulatory powers granted by Congress.<sup>55</sup> After considering the work of accounting firms that audit registrants’ financial statements, the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce found that the “SEC’s reliance on the private accounting profession alone to assure that corporate records are examined by independent auditors has been insufficient to protect public investors and to accomplish the objectives of the Federal securities laws.”<sup>56</sup>

The Senate hearings began with a staff study prepared for the Subcommittee on Reports, Accounting, and Management that was critical of the accounting profession. The staff study stated, “Reforms are needed to restore public confidence in the accuracy and reliability of financial and other information reported by publicly-owned companies.”<sup>57</sup> During the several months that followed, the Subcommittee gathered extensive information from accounting firms, the Commission, and others. At the conclusion of the hearings, the Senate Subcommittee Report stated, “Self-initiated action by the private sector in cooperation with the SEC is the method of reform preferred by subcommittee members.”<sup>58</sup>

The Commission’s involvement in issues related to the AICPA’s self-regulatory processes, which included the establishment in 1977 of the POB, increased during and after these congressional hearings. The Commission undertook to oversee, and annually report to Congress on, the profession’s response to Congressional concerns.<sup>59</sup> The 1977 self-regulatory system is described in more detail in Appendix A.

As concerns about the quality of financial reports has increased in recent years, the POB, the Commission and others began to call for an update to the governance mechanisms of the POB, which were adopted soon after it was formed in 1977. While intended to be autonomous (the POB could set its own budget, establish its own operating procedures, and appoint its own members, chairperson, and staff), the POB relied for its funding on voluntary dues paid by AICPA firms that audited public companies and belonged to the AICPA section composed of such firms—SECPS. In addition, the POB lacked the ability to organize and implement its own quality control reviews. And, the POB was not given any authority to sanction auditors for deficiencies or incompetence noted during quality control reviews.

<sup>57</sup> Staff of Subcomm. on Reports, Accounting, and Management of the Senate Comm. on Government Operations, 95th Cong., *Report on the Accounting Establishment: A Staff Study*, 20 (Subcomm. Print Mar. 31, 1977).

<sup>58</sup> Staff of Subcomm. on Reports, Accounting, and Management of the Senate Comm. on Governmental Affairs, 95th Cong., *Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors* 4 (Subcomm. Print Nov. 4, 1977).

<sup>59</sup> *Accounting and Auditing Practices and Procedures: Hearing Before the Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs* (June 13, 1977) (statement of Harold M. Williams, Chairman, U.S. Securities and Exchange Commission).

<sup>51</sup> *Id.*

<sup>52</sup> See H.R. 3763, *the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002: Hearing Before the House Comm. on Financial Services* (Apr. 9, 2002) (statement of Richard C. Breeden, Former Chairman, U.S. Securities and Exchange Commission 1989–93) (“[T]here is only one governmental ‘regulator’ for the accounting industry, and that regulator is now and should remain the SEC. The SEC has the history, the culture and the institutional strength to be able to stand up to any wrongdoer. However, private sector groups working under the SEC’s aegis can extend the reach of supervision in a healthy fashion.”); *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Feb. 14, 2002) (statement of Paul A. Volcker, Chairman of the Trustees of the International Accounting Standards Board and Former Chairman, Board of Governors of the Federal Reserve System) (“[E]xperience strongly suggests that governmental oversight, with investigation and enforcement powers, is necessary to assure discipline \* \* \*. [T]his committee will want to explore means for providing more “backbone” for industry oversight, either through legislation or by encouraging exercise of SEC regulatory authority. Better means of identifying professional misconduct, with the possibility of meaningful fines and withdrawal of professional licenses, appears essential.”); *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Mar. 5, 2002) (statement of Joel Seligman, Dean and Ethan A.H. Shepley University Professor, Washington University School of Law) (“I believe at this time a new auditing self-regulatory organization is necessary. It should replace not just the POB, but a byzantine structure of accounting disciplinary bodies which generally have lacked adequate and assured financial support; clear and undivided responsibility for discipline; and an effective system of SEC oversight.”); *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Mar. 6, 2002) (statement of Shaun O’Malley, Chair of the 2000 Public Oversight Board Panel on Audit Effectiveness, and Former Chair, Price Waterhouse LLP) (“I am in favor of the creation of an organization to oversee the accounting profession, whether it is created by regulation or by legislation.”).

<sup>53</sup> Staff of Subcomm. on Reports, Accounting, and Management of the Senate Comm. on Government Operations, 95th Cong., *Report on the Accounting Establishment: A Staff Study*, 7 (Subcomm. Print Mar. 31, 1977).

<sup>54</sup> See, e.g., H.R. 13175, 95th Cong. (1978).

<sup>55</sup> See Staff of Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong., *Report on Federal Regulation and Regulatory Reform*, 1 (Subcomm. Print Oct. 1976). (also known as the “Moss Report”).

<sup>56</sup> *Id.* at 38.



Discussions among the Commission staff, POB, SECPS, AICPA, accounting firms, and others, culminated in the adoption of a new POB charter in February 2001. The principal features of the new charter included:

- Oversight of the SECPS and, for the first time, oversight of the Auditing Standards Board and the now-defunct Independence Standards Board;
- Expanded responsibility for improving communications among various bodies involved in the profession's regulatory processes;
- Expanded responsibilities to undertake special reviews and projects; and
- Increased funding from the SECPS.<sup>60</sup>

Even under the new charter, however, the POB lacked the express authority to direct the review of a firm's quality control system or to discipline a firm, or persons in a firm, for noncompliance with professional standards or the SECPS membership requirements. The new charter also provided that the SECPS would continue to be the sole source for the POB's funding, and required the SECPS to approve funding for the POB's special or unanticipated projects and for any amount above the \$5.2 million annual limit set forth in the charter.<sup>61</sup>

#### *E. A New System of Private Sector Oversight Will Address Current Problems and Increase Investor Confidence*

The private sector framework we are proposing would provide reasonable assurance to investors and to the Commission that accounting firms' audit, review, and attest procedures, which are required by the securities laws and Commission regulations, fulfill their statutory and regulatory purposes, and thereby will increase assurances that financial reporting, also required by the securities laws and Commission regulations, meet applicable legal and regulatory requirements. While no system of private sector or government regulation can ensure one hundred percent compliance with professional standards, we believe that this system

would enhance investors' confidence that accounting firms are performing their public responsibilities and that, therefore, the financial information published by registrants and issuers is reliable.

After full consideration of the weaknesses of the present system and how it can be improved, we have based our proposed rules on the position that a PAB should reflect eight core principles:

1. *A PAB should be separate from, and independent of, the AICPA*—Despite the POB's oversight, significant failures in the auditing process continue to exist. In addition, there is a perceived conflict between the AICPA's dual roles of serving the best interests of its membership and serving investors. To restore confidence in the system, we believe that it is necessary for a new PAB to be established, operated, and overseen completely outside of the profession.

2. *Requirements as to financial statements*—To assure that the benefits of the oversight process extend to investors in all public companies, the financial statements of an SEC-registered company would not comply with Commission requirements unless the company's accountants were members of a PAB and the company was a member of, and thereby bound to cooperate in any review or proceeding commenced by, the same PAB as its accountants. In the Commission's view this is necessary to assure cooperation and access necessary to carry out its reviews, quality control, and disciplinary activities over the accounting profession.

3. *A PAB should operate under the SEC's oversight*—The SEC's relationship with the POB was based on the desire of the profession and the POB to provide assurance to Congress and to the public that the peer review process and related programs were working well. The SEC had limited ability to affect the work of the POB or the peer review program. Under the new framework, the Commission would recognize a PAB after reviewing, and being satisfied with, among other things, the entity's charter, by-laws, proposed budget, and proposed board members. The SEC would have the ability to review, alter, modify, or abrogate any PAB rule and to review any PAB disciplinary action.

4. *Public members should dominate a PAB*—To be credible, it must be clear that the PAB is an independent organization and places the public interest and the interest of investors above all else. A PAB would be a diverse board, dominated by persons

who are not associated with the accounting profession and who are in the position to make all significant decisions on quality control and disciplinary issues.

5. *A PAB should have an independent and dependable funding source*—A PAB must have an independent and dependable funding source. The POB was funded by the AICPA, which called into question its ability to act totally separate from the profession. To assure continuity and independence, a PAB should be neither controlled nor principally funded by members of the accounting profession. A PAB's operations should be funded on a non-voluntary basis through the assessment of fees on accounting firms who are members of the PAB and on those firms' audit clients, the reliability of whose financial reporting would be presumptively benefited by the activities of the PAB.<sup>62</sup>

6. *For larger firms, annual PAB-directed reviews of firms' quality controls for accounting, auditing, and auditor independence should replace triennial firm-on-firm peer reviews*—While individuals within accounting firms generally regard firm-on-firm peer reviews as serious events that can affect their careers, investors and critics of the program often consider such reviews among the limited number of large firms to be a "one hand washes the other" approach to regulation.<sup>63</sup> In addition, the triennial reviews are too infrequent for large firms.<sup>64</sup>

7. *A PAB should have the ability to discipline firms and individuals and be able to impose a wide range of sanctions, including the ability to require an accountant to no longer audit a particular public company*—A primary criticism of the current system is that it does not include effective disciplinary proceedings. The strongest sanction issued by the AICPA is expulsion from that organization, which does not remove the individual or firm

<sup>62</sup> See, e.g., SEC Roundtables, *supra* note , at 38 (Mar. 6, 2002) (statement of Ted White, Corporate Governance Director, California Public Employees' Retirement System) ("I would suggest some of the key tenets be \* \* \* a board that consisted of independent members with solely independent funding").

<sup>63</sup> See, e.g., Editorial, Watching the Watchers, Wash. Post, May 21, 2002, at A16; SEC Roundtables, *supra* note , at 55–56 (Mar. 4, 2002) (statement of William Allen, New York University Law School) (suggesting that the public perception of the current peer review process is an "I scratched your back, you scratch my back organization").

<sup>64</sup> See Letter from Robert J. Kueppers, Chair, SECPS Executive Committee, to Managing Partners of SECPS Member Firms, (Mar. 21, 2002), which announces new requirements for member firms with more than 500 SEC clients to undergo annual review procedures during each of the years between triennial peer reviews.

<sup>60</sup> POB, *Annual Report 2000*, at 5. The POB charter is available at <http://www.publicoversightboard.org/charter.htm>.

<sup>61</sup> The new POB charter also fell short of instituting all of the recommendations of the Panel on Audit Effectiveness. For example, the Panel had recommended that the POB should approve all appointments to the Auditing Standards Board and SECPS Executive Committee, that the POB oversee the AICPA's evaluations, compensatory hiring and promotion decisions with respect to the staff of the AICPA committees it was to oversee, and the establishment of "no strings attached" funding for the POB. The Panel on Audit Effectiveness, *Report and Recommendations* 140 (Aug. 31, 2002).



from practice before the Commission. We believe that we should continue to pursue violations of the securities laws and disciplinary actions under Rule 102(e). We also believe, however, for a PAB's quality control system to have "teeth" the PAB should have the ability to discipline its member accountants for incompetent, unethical, or other deficient conduct discovered during a quality control review or that otherwise comes to its attention, and that it must be able to sanction accounting firms for deficient quality control systems. The public must be assured that a PAB would be expected to and able to take appropriate and meaningful action to address incompetent or unethical conduct and violations of professional standards.

8. *A PAB should issue public reports of its activities*—Although the POB issued an annual report, the SECPS has not issued a separate public report since 1997. To promote the understanding of its processes and to inform the public of the results of its programs and proceedings, a PAB should issue reports to the public at least annually and, to the extent possible, on a real time basis, that describe the PAB's quality control and disciplinary activities, contain the PAB's audited financial statements, explain the fees it has imposed on its members, and other information.

The Commission invites comments on these factors, including suggestions for alternative or additional factors that should lay the foundation for our rules. In addition, the Commission invites and encourages persons who would consider forming a PAB to begin a dialogue with the Commission as soon as possible. The Commission will make itself available for meaningful dialogue to further and facilitate the timely establishment of a PAB.

### III. Discussion of Proposed Rules

We are proposing to amend and add rules to Regulation S-X. To assure that the benefits of the oversight process extend to investors in all public companies:

- An SEC registrant's financial statements would not comply with Commission requirements unless the accountants who have audited or reviewed those statements are members of a PAB. Attest reports would not comply with Commission requirements unless prepared by outside accountants who are members of a PAB; and
- An SEC registrant's financial statements and attestation reports contained in or accompanying an SEC registrant's reports or registration statements would not comply with Commission requirements unless the

registrant is a member of the same PAB as its accountants, and thereby is bound to cooperate in that PAB's reviews or proceedings regarding the registrant's accountant.

For the Commission to recognize a PAB, a PAB would have to meet certain conditions and perform certain functions. We also are proposing to require disclosure if an executive officer, director, or person nominated to become a director of a public company has been sanctioned as a member accountant by a PAB within the last five years.

#### A. Regulation S-X Definitions

Rule 1-02 contains the general definitions for terms used throughout Regulation S-X.<sup>65</sup> Although the terms "review" and "attest" are common to accountants, they have never been defined within Regulation S-X. Because those terms are used in the rules we are proposing in this release, and in other rules within Regulation S-X,<sup>66</sup> we are proposing to define them in rule 1-02(d). Each proposed definition codifies the current common understanding of the term by referring to GAAS and to Statements on Standards for Attestation Agreements,<sup>67</sup> as may be modified by the Commission.

We solicit comments on the above definitions. Do the definitions of "review" and "attest" capture the understanding of the words common to accountants? Should the definitions differ from those in GAAS? If so, why and in what way? Are there reasons why we should not define "review" or "attest" in the rule? Should we narrow or broaden the definitions? If so, how?

#### B. Requirements for Financial Statements and Attestation Reports

##### Qualifications of Accountants

Existing Commission regulations state that accountants are not qualified to practice before the Commission unless they are licensed under the laws of the place of their residence or principal office, and are independent from their audit clients.<sup>68</sup> As a practical matter, however, it has long been recognized that, in addition to these two qualifications, auditing a public

company requires special expertise.<sup>69</sup> The foundation for that expertise has been developed over many generations of accountants practicing before us and is embodied in professional standards for auditing, attestations, quality controls, ethics, and other areas. These standards guide accountants in their daily work of examining the accuracy and completeness of financial information disclosed by management to investors. It is imperative, therefore, that auditors reach reasoned decisions that are well grounded in these professional standards.

Further, as we stated when we revised our auditor independence rules in 2000, auditor independence is instrumental to the financial reporting process and to investor confidence in financial statements.<sup>70</sup> Investors will commit their savings to an impersonal securities market only if they know that unbiased auditors take a critical look at managements' decisions and processes used to prepare the financial statements and that those auditors will place the concerns and interests of investors above not only the company's interests but above the accountant's self-interest as well.<sup>71</sup>

Strong oversight of the profession helps to (and one goal of a PAB is to) strengthen firms' audit practices and to detect and deter weaknesses that might detract from an accountant's ability to fulfill professional standards of ethics and competence and requirements of auditor independence. In performing quality control reviews and through the disciplinary process, a PAB would play an important role in identifying and addressing competency, ethics, independence, and other professional practice issues.<sup>72</sup>

In recognition of the critical importance in having auditors well-versed in professional standards operating under effective quality control systems, proposed rule 2-01(a)(2) would state that the Commission would not recognize any accountant to be a "certified public accountant" or "public accountant," or as "independent" with respect to an audit client if, during the

<sup>69</sup> See generally SECPS membership requirements. See also SAS No. 1, § AU 210.

<sup>70</sup> *Revision of the Commission's Auditor Independence Requirements*, Securities Act Release No. 33-7919 (Nov. 21, 2000), 65 FR 76008 (Dec. 5, 2000).

<sup>71</sup> *Relationships Between Registrants and Independent Accountants*, Accounting Series Release No. 296 (Aug. 20, 1981), 46 FR 43181 (Aug. 27, 1981).

<sup>72</sup> The securities laws require, or authorize the Commission to require, that registration statements and reports include financial statements that have been audited by an independent public or certified public accountant. See *supra* note 12.

<sup>65</sup> 17 CFR 210.1-02.

<sup>66</sup> See e.g., Rule 10-01(d) of Regulation S-X, 17 CFR 210.10-01(d), which requires that quarterly financial statements in Forms 10-Q be reviewed by an independent accountant prior to a registrant filing its Form 10-Q with the Commission.

<sup>67</sup> See generally SAS No. 71, AU § 722 (as revised by SAS No. 90). See also Attestation Standards: Revision and Recodification, Statement on Standards for Attestation Engagements No. 10 (Jan. 2001).

<sup>68</sup> 17 CFR 210.2-01.

professional engagement period, that accountant is not a member in good standing of a PAB (*see below for discussion of the definition of "member accountant in good standing"*). A PAB's oversight of accountants, particularly as to independence issues, will in some cases require a PAB to consider information that can be supplied only by the audit client. We therefore believe that the purposes of the statutory requirements will be advanced significantly if an audit client is a member of the same PAB as its accountant, and thereby agrees to supply information in connection with that PAB's reviews and proceedings regarding the accountant. Accordingly, the proposed rule contemplates that an audit client be an adjunct member of the same PAB of which its accountant is a member.

#### Registrants' Reports and Registration Statements

Under the same reasoning as discussed above, proposed rule 13-01(a) requires reports and registration statements filed with the Commission that contain financial statements<sup>73</sup> be audited or reviewed by an accountant that: (1) Is a member in good standing of a PAB of which the registrant<sup>74</sup> filing the report or statement is an adjunct member in good standing, and (2) satisfies all other requirements prescribed by the federal securities laws and the rules and regulations thereunder concerning an accountant that audits, reviews, or prepares such report or registration statement.

We request comment on proposed rules 2-01(a)(2) and 13-01(a), including the approach and structure of those rules for the filing with the Commission of financial statements and attestation reports. Are the definitions appropriate? Will they further the goals of enhanced oversight of the financial reporting process and enhanced quality of financial information? We request comment on the aspect of the proposed

rule regarding registrant membership. Should registrants be adjunct members? Could our objectives be accomplished other than by having registrants be adjunct members—for example, by simply requiring registrants to participate in funding a PAB and to cooperate with a PAB's reviews and proceedings? Why or why not? We solicit comment on alternative frameworks to accomplish our goals. For example, if registrants can demonstrate that their accountants have an alternative system or process that meets the objectives of our rules (*e.g.*, through third-party reviews or other organizations), should the registrants be exempted from the operation of the rules, in particular Rules 2-01(a)(2) and 13-01? Should such systems or processes be required to operate with our approval and under our oversight? In addition, we solicit comment on what role, if any, exchanges and the National Association of Securities Dealers ("NASD") should play with respect to a PAB.

Investment advisers, certain broker-dealers, transfer agents and certain other entities that file audited financial statements with us are not considered to be "registrants" under Regulation S-X because they are not issuers of securities and, therefore, would not fall within Article 13. Nonetheless, because the auditor independence rules discuss "audit clients" and not registrants, auditors of such entities' financial statements, and the entities, would be subject to the proposed rules. Is this appropriate? Should entities that are not registrants be outside the scope of the proposed rules? Should accountants that audit only entities that are not issuers of securities be outside the scope of the rules?

The proposals utilize the definition of "audit client" that is contained in Rule 2-01(f)(6) of Regulation S-X. That definition includes affiliates of the audit client. We request comment on the application of that definition to the rules proposed in this release. Should the definition of "audit client" include affiliates for purposes of the proposed rules? Why or why not? Are there special concerns in the investment company, investment adviser, or broker-dealer context that are raised because of the inclusion of affiliates?

#### C. Definitions for Article 13

In addition to providing definitions for use throughout Regulation S-X, the proposed rules would provide certain definitions of terms that would have a specific meaning for the purposes of Article 13 and a PAB.

*Accountant.* Proposed rule 13-02(a) would define "accountant" for the purposes of Article 13. This definition has two important characteristics. First, it encompasses both accounting firms and individual accountants. Second, it limits the term "accountants" to those public or certified public accountants and firms engaged in auditing or reviewing financial statements, or preparing attest reports, that are filed with the Commission. The definition is similar to the definition of "accountant" in our auditor independence rules.<sup>75</sup>

Is this definition appropriate? Is it appropriate for the definition to include both accounting firms and individual accountants? Would the goals of the proposed rules be better or more appropriately accomplished if only one or the other was required to be a PAB member? Does this definition raise practical problems for firms that have partners who specialize in tax or other non-audit services, but also may be consulted briefly during an audit? For example, a firm might wish to have a tax partner consult for a very brief time with an audit engagement partner about a company's tax accrual. Would requiring such partners to be members of a PAB pose an unnecessary burden on the partners or accounting firms? If there would be an unnecessary burden, what would that burden be and is there any empirical data that would quantify such a burden?

*Adjunct member in good standing.* Under proposed rule 13-02(b), an entity is an "adjunct member in good standing," when the entity is an adjunct member of a PAB and is not delinquent (as defined in proposed rule 13-02(c)) in paying fees assessed by the PAB, or in appropriately responding to a PAB's request for documents and testimony relevant to a PAB quality control review, supplemental review, or disciplinary proceeding concerning the adjunct member's accountant. With respect to documents and testimony, the adjunct member's "good standing" would turn on whether it has produced documents that a PAB has requested from the adjunct member or its management, provided testimony that a PAB has requested from the adjunct member or its management, and used best efforts to cause its agents and non-management employees to supply any documents and testimony requested

<sup>73</sup> *See, e.g.*, Section 13(b)(1) of the Exchange Act, 15 U.S.C. 78m(b)(1), which states, "The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth \* \* \*. Regulation S-X, 17 CFR 210, prescribes the form and content of financial statements filed with the Commission.

<sup>74</sup> "Registrant" is defined in rule 1-02(t) of Regulation S-X, 17 CFR 210.1-02(t), to mean "the issuer of the securities for which an application, a registration statement, or a report is filed." As discussed above, for purposes of proposed amendments to § 210.2-01, adjunct membership requirements would also extend to "audit clients." Accordingly, throughout the discussion in this release, any reference to "registrant" should also be understood to encompass "audit client" where the context requires.

<sup>75</sup> Rule 2-01(f)(1) of Regulation S-X, 17 CFR 210.2-01(f)(1), which states, "Accountant \* \* \* means a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated."

from it by the PAB.<sup>76</sup> In defining “good standing,” the proposed rule provides only for “best efforts” by an adjunct member with respect to non-management employees and agents. While such employees may often have documents and knowledge relevant to a PAB review or disciplinary proceeding, we are concerned about making the good standing of every public company turn on its ability to preclude any single employee from refusing to cooperate with a PAB review or proceeding. Rather, an adjunct member will remain in good standing as long as it uses its best efforts to cause those employees and other agents to comply with PAB requests for testimony, and so long as the adjunct member and its management provide all requested documents and testimony and the adjunct member is timely in paying fees assessed by the PAB.

We invite comments on alternative approaches. Are there other, preferable, ways to define or condition an audit client’s good standing that are sufficient to achieve the goals of PAB funding and PAB access to information relevant to its mission? Should the good standing of an adjunct member be contingent on willingness of management to testify? How should former management be treated? How, if at all, should “management” be defined for these purposes? Should more than management be covered by the requirement? For example, our auditor independence rules use the defined term “accounting role or financial reporting oversight role.”<sup>77</sup> Should the proposed rule include all or any of the individuals covered by that definition? Should the rule cover directors? With respect to non-management employees and agents, is it appropriate for the rule to require only that the adjunct member make best efforts to secure from them any documents or testimony requested by the PAB, or should the adjunct member’s good standing depend upon the adjunct member actually causing the employee or agent to supply the documents and testimony? Is there an appropriate intermediate approach to addressing that issue? Alternatively, should the standard be “reasonable efforts” instead of “best efforts.”

**Delinquent.** Under proposed rule 13–02(c), a member or adjunct member of a PAB is “delinquent” when a PAB has provided public notice (consistent with

proposed section 13–04(d)(11)) that the member or adjunct member has failed to pay the fees assessed by the PAB, or has failed to produce required documents or provide required testimony after any good faith legal objection to the request for documents or testimony has, in accordance with the PAB’s rules, been resolved in the PAB’s favor. An adjunct member may also be determined to be delinquent if it fails to use best efforts to cause its non-management employees and agents to supply requested documents or testimony.

A PAB’s ability to obtain fees, documents, and testimony from members and adjunct members would be critical to the PAB’s ability to carry out the purposes of the proposed rules. Accordingly, becoming delinquent in paying or responding to a PAB request, in accordance with a PAB’s rules, automatically terminates the good standing of a member or adjunct member.

Under proposed rule 13–04(d)(11), discussed below, a PAB must devise a rule for advance public notice of the danger of a delinquency, sufficient to give audit clients an opportunity to prepare for such a delinquency and the consequent potential loss of good standing by their accounting firm.

In addition, proposed rules 13–04(d)(7) and 13–04(d)(11) condition a PAB’s Commission recognition on the PAB having fair procedures for requesting documents and testimony and for resolving any disputes concerning those requests or concerning fees. We would expect a PAB to take seriously the need for full and fair procedures before making a delinquency determination as to a member or adjunct member asserting a good faith legal basis for objecting to any request for documents or testimony.<sup>78</sup>

<sup>78</sup> We would expect that, with respect to good faith assertions of privilege, a PAB would adopt a reasonable approach comparable to that of other private organizations or similarly situated private parties. Cf. *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 161–63 (2d Cir. 2002) (interview demand issued by private membership organization to a member lacked sufficient nexus to government inquiry to trigger Fifth Amendment protection, since organization was not state actor and interview demand was not result of collusion with government) (citing *Desiderio v. National Association of Securities Dealers, Inc.*, 191 F.3d 198, 206 (2d Cir. 1999), cert. denied, 531 U.S. 1069 (2001) (rejecting constitutional challenges to NASD action because “NASD is a private actor, not a state actor”) and *United States v. Solomon*, 509 F.2d 863, 867–71 (2d Cir. 1975) (rejecting Fifth Amendment challenge to New York Stock Exchange inquiry of member because New York Stock Exchange is not government actor)). We would specifically expect, however, that a PAB would not honor any assertion of an accountant-client privilege. An accountant client privilege is not recognized under federal law. See *United States v. Arthur Young & Co.*, 465 U.S.

We request comment on the proposed definition of delinquent. Are the proposed notice provisions appropriate? Are there other additional circumstances when a member or adjunct member of a PAB should be considered delinquent? What are they? Should the rule explicitly identify specific privileges or categories of privileges that a PAB may not invade? If so, what are they?

**Foreign Accountant.** We have proposed in rule 13–02(d) to define “foreign accountant” to mean an accountant:<sup>79</sup> (1) Having a place of residence and principal office outside the United States and its territories, and (2) not licensed in the United States or its territories. If an accountant resides, practices, or is licensed in the United States, that accountant would be subject to the proposed rules. In this regard, if a foreign-licensed accountant resides in the United States as a result of a temporary assignment to work at a U.S. firm, he or she might be subject to the proposed rules. We intend for the PAB, however, to consider such issues and the many variations of working relationships that may arise in the operation of the firms’ international organizations and, if considered necessary or appropriate, to interpret this provision, adopt related rules, or request amendments to the Commission’s definition.

Is the proposed definition of “foreign accountant” appropriate? Is the requirement that both the residence and principal place of business be outside the United States and its territories unduly restrictive, or not restrictive enough? Are there other factors that should be included in the definition? Is the intent to permit a PAB to consider this issue appropriate? Does the proposed definition provide sufficient flexibility for a PAB to consider these issues?

**Member accountant in good standing.** Proposed rule 13–02(e) describes the requirements that an accountant must satisfy to be a member accountant in good standing with a PAB. First, the accountant must be a member of the PAB, a status that would be obtained through enrollment procedures devised by a PAB pursuant to proposed rule 13–04(d)(1). In addition, status as a member

805 (1984); *Couch v. United States*, 409 U.S. 322 (1973). Further, the recognition of such privilege by a PAB would significantly impair its ability to further the goals and purposes of federal securities laws reflected in the proposed rules.

<sup>79</sup> As noted previously, under proposed rule 13–02, the term “accountant” includes both individuals and firms, but is limited to those auditing or reviewing financial statements or preparing attestation reports filed with the Commission.

<sup>76</sup> As discussed with respect to the definition of “delinquent,” below, we expect that a PAB will adopt reasonable practices and procedures for dealing fairly with good faith assertions of legal objections to document and testimony requests.

<sup>77</sup> Rule 2–01(f)(3) of Regulation S–X, 17 CFR 210.2–01(f)(3).

accountant in good standing involves two further elements that must be satisfied. The first element is satisfied if the accountant has not been barred, suspended, or otherwise sanctioned by a PAB. Alternatively, if the accountant has been barred, suspended or otherwise sanctioned, the first element is satisfied if the accountant has been reinstated by the PAB after having been barred or suspended, or if the accountant has not been cited by the PAB in a public notice as being noncompliant with the terms and conditions of any other sanction imposed by the PAB. The second element is rooted in the need to ensure funding of, and cooperation with, a PAB, and so is similar to the requirements to be an adjunct member in good standing, described above. Specifically, an accountant satisfies the second element if the accountant is not delinquent in paying fees or supplying required documents and testimony. The documents and testimony that must be supplied at a PAB's request in order for the accountant to remain in good standing are the accountant's documents and testimony and the documents and testimony of any of the accountant's employees, or other agents.<sup>80</sup> Should the rule prescribe different limits on the documents and testimony that an accountant must provide to maintain good standing? Are there other factors that the rule should take into account for purposes of determining "good standing?"

#### *Public Accountability Board.*

Proposed rule 13-02(f) would define the term "Public Accountability Board" or "PAB" to mean an entity that is organized in accordance with, and for the purposes described in, proposed Article 13, and that is recognized by the Commission.

*Professional Engagement Period.* Both proposed rule 2-01(a)(2) and proposed rule 13-01 operate by reference to the "professional engagement period." Under the operation of those rules, if either the accountant or the audit client is not a member in good standing with a PAB for any portion of the professional engagement period, the financial statements and attestation reports included in or accompanying that audit client's filings with the Commission will not be acceptable. We consider it important that any failure of good standing during the professional engagement period have significant consequences since auditors must be

independent during the professional engagement period, and we do not want to permit any gamesmanship with respect to cooperating with the PAB.

The term "professional engagement period" is defined in proposed rule 13-02(g) to begin when an accountant either signs an engagement contract to review or audit financial statements or to prepare an attestation report, or begins audit, review, or attest procedures, whichever is earlier. The period ends when the registrant or accountant notifies the Commission that the registrant is no longer the accountant's audit client.<sup>81</sup> This definition parallels the definition of the same term in the auditor independence rules.<sup>82</sup>

Does the proposed definition capture the appropriate period? Is there a different beginning point that would be more appropriate? Would a different end point be appropriate?

*Professional Standards.* Proposed rule 13-02(h) defines "professional standards" to include accounting,<sup>83</sup> auditing,<sup>84</sup> and attestation standards,<sup>85</sup> the Commission's auditor independence regulations,<sup>86</sup> the standards of the Independence Standards Board, and any other standards related to the audit, review, or preparation of financial statements filed with the Commission. These standards would include those set, or designated as authoritative, by a PAB, including auditing, quality control, or ethics standards. Does this definition capture all of the standards and regulations that are needed and appropriate?

*SEC clients.* Proposed rule 13-03(i) defines the term "SEC clients." We have defined this term, which is distinct from "registrant," for the very limited purpose of identifying the dividing line (by reference to the number of "SEC clients") between those accounting firms that will be subject to an annual quality control review and those (with fewer SEC clients) that will be subject

to a triennial quality control review. For consistency, we have incorporated into the proposed rule the definition of "SEC clients" that is found in the AICPA's bylaws and resolutions,<sup>87</sup> but we have provided a PAB with the ability to amend the definition to add entities that the PAB believes should be considered to be SEC clients for the purpose of this rule. Under the AICPA definition, SEC clients include issuers in initial public offerings and registrants filing periodic reports under the Exchange Act (except broker-dealers filing only because of section 15(a) of that Act<sup>88</sup>) or the Investment Company Act. With respect to SEC clients, should companies whose reporting obligations arise solely under Section 15(d) of the Exchange Act be included within the definition of SEC clients?

We also generally request comment on all of the definitions in the proposed rule, including the proposed scope of those definitions, and whether there are additional definitions that should be added or proposed definitions that should not be included in any final rules?

#### *D. Commission Recognition of Public Accountability Boards*

A PAB must be an organization that places the interests of investors above all else. To assure the ability and desire of an entity to represent investors and promote high quality financial reporting, the Commission would study carefully each organization before determining whether to recognize it as a PAB under the proposed rules. In this regard, proposed rule 13-03(a) would require that each entity desiring to become a PAB make a submission to the Commission containing the representations and materials necessary for the Commission to determine the entity's ability to carry out the functions and to accomplish the purposes that are described in Article 13. As noted in proposed rule 13-03(b), the Commission may ask the entity to supplement its submission with additional information.

Proposed rule 13-03(b) also indicates that the Commission would, consistent

<sup>81</sup> Such notice may occur under item 4 of Form 8-K, 17 CFR 249.308.

<sup>82</sup> 17 CFR 210.2-01(f)(5)(ii)(A) and (B).

<sup>83</sup> The Financial Accounting Board ("FASB") and other sources establish generally accepted accounting principles ("GAAP") used to prepare financial statements filed with the Commission. For the "hierarchy of GAAP," see SAS No. 69, AU § 411.

<sup>84</sup> The AICPA's Auditing Standards Board ("ASB") issues SAS. Under Rule 202 of the AICPA's Rules of Professional Conduct, AICPA members must adhere to these standards or be prepared to justify any departures from them. The ASB's Audit Issues Task Force is assigned the responsibility to provide timely guidance on the application of the ASB's pronouncements.

<sup>85</sup> The AICPA's ASB issues Statements on Standards for Attestation Engagements, or SSAEs.

<sup>86</sup> 17 CFR 210.2-01.

<sup>87</sup> AICPA Bylaw section 230R, Implementing Resolutions Under Section 2.3.5 for Definition of "SEC Client" (As adopted by Council Jan. 8, 1990), which states:

That for purposes of section 2.3, an SEC Client is

- An issuer making an initial filing, including amendments, under the Securities Act of 1933.
- A registrant that files periodic reports (for example, forms N-SAR and 10-K) with the SEC under the Securities Exchange Act of 1934 (except brokers or dealers registered only because of Section 15(a) of that Act) or the Investment Company Act of 1940.

<sup>88</sup> 15 U.S.C. 78o(a).

<sup>80</sup> As discussed above with respect to the definition of "delinquent," we expect that a PAB will adopt reasonable practices and procedures for dealing fairly with good faith assertions of legal objections to document and testimony requests.

with the public interest and for the protection of investors, decide whether to recognize an entity as a PAB based on the entity's commitment and capacity to carry out the functions and accomplish the purposes of the proposed rules. The Commission would make its determination by issuance of a Commission order.

We request comment on the procedures for Commission recognition of a PAB. In particular, is the standard for recognition of a PAB appropriate? Should we base our determination on factors other than or in addition to the entity's commitment and capacity to carry out the functions and to accomplish the purposes of the proposed rules? What other factors should the Commission consider?

Proposed rule 13-03(c) sets forth the information to be submitted to the Commission by an entity seeking recognition as a PAB. Under proposed rule 13-03(c)(1), the entity's submission must include its organizational structure, proposed budget, and proposed board members and terms of board membership. This information must be sufficient for the Commission to determine that the entity will satisfy the requirements set out in proposed section 13-04(b), and discussed below. Under proposed rule 13-03(c)(2), the proposed PAB must submit its charter and bylaws. Specific criteria that the charter and bylaws must satisfy are set out in proposed section 13-04(c) and discussed below. We solicit comment on the materials that a PAB should submit to the Commission when seeking recognition as a PAB. Are these materials appropriate for the Commission to require? Are there other materials regarding the organization of an entity seeking recognition as a PAB that the Commission should require or review to inform its determination of whether to recognize a PAB? For example, should we require an entity seeking to be recognized to submit its rules, membership requirements, and descriptions of its systems and procedures for our review before we make a determination about recognition?

In seeking recognition as a PAB, under proposed rule 13-03(c)(3), an entity would represent that it would pursue certain goals, such as to work to improve the quality of member firms' audits and reviews; work to improve member firms' quality controls and compliance with auditor independence and ethics requirements; enhance investor confidence in the audit process; and foster cooperation and coordination among private sector standard-setting bodies.

Proposed rule 13-03(c)(4) requires an entity seeking Commission recognition as a PAB to represent that it would establish rules, membership requirements, systems and procedures designed to further the goals described in proposed rule 13-03(c)(3) and sufficient to accomplish, at a minimum, the further objectives described in proposed section 13-04(d), and discussed below. With regard to proposed rules 13-03(c)(3) and (4), are these appropriate representations for the Commission to require? More generally, are there additional representations or information that an entity should be required to provide to aid the Commission's determination of whether to recognize the entity as a PAB?

Finally, proposed rule 13-03(c)(5) would require an entity seeking recognition as a PAB to represent that it would study and monitor quality control developments in other countries and report periodically to the Commission on whether the exemption for foreign accountants in proposed rule 13-07, discussed below, should be withdrawn. A PAB may recommend that the exemption be maintained, withdrawn in whole or part, or modified to place conditions on the receipt of the exemption. Although not stated in our proposed rules, a PAB also may choose to participate in efforts to develop and improve international or foreign national auditing, quality control or ethics standards. With regard to proposed rule 13-03(c)(5), is this an appropriate and useful study for a PAB to conduct? What should be the time frame of the study? Are there other areas that we should require a PAB to study and report on to the Commission?

#### *E. Conditions of Commission Recognition of Public Accountability Boards*

Proposed section 13-04 sets conditions to ongoing Commission recognition of a PAB. An entity seeking recognition as a PAB under proposed section 13-03 must meet certain of these requirements, specifically those contained in subsections (b) and (c), at the time of its initial request for recognition. For continued recognition by the Commission, the criteria in this section must be met on an ongoing basis. For the reasons described below, we believe that these conditions are necessary to ensure that a PAB acts in the public interest, consistently with the rules.

#### *Organizational Structure, Board Membership, and Budget*

To improve investor confidence in the integrity of the oversight process, a PAB

must be, and must be perceived by investors to be, dominated by representatives of investors and issuers, or "public members," as opposed to representatives of the accounting profession. Proposed rule 13-04(b) sets forth several requirements for the structure, membership, and budget of a PAB designed to ensure that public board members dominate all aspects of a PAB's activities. First, proposed rule 13-04(b)(1) would require that a PAB have a fixed number of board members, none of whom are, or have been at any time in the previous two years, an employee of an accountants' professional organization.<sup>89</sup> Additionally, no more than one-third of the members, and in no event more than three of the members, may be, or have been at any time in the ten year period preceding his or her PAB term: (1) An accountant; (2) a partner, principal, shareholder, or managerial employee of an accounting firm; or (3) a retired partner, principal, shareholder, or managerial employee of an accounting firm.

The proposed rule does not set the number of PAB board members, but rather leaves this to a PAB's discretion. In this regard, however, because of the variety of functions to be performed by the PAB, we suggest that a PAB consisting of nine members likely could meet the objectives of the rule.

We believe that having a small minority of accountants on a PAB would be appropriate because of the functions we anticipate a PAB would perform. Under the previous self-regulatory system, the POB had five members who had not been, or had not recently been, members of the accounting profession. That regulatory system also contained, however, the SECPS Executive Committee, the Peer Review Committee, and the QCIC, which were comprised entirely of active or retired accountants. We envision a PAB taking over the work of not only the prior POB but also much, if not all,

<sup>89</sup> One of our core principles for a PAB is that it be outside the auspices of the AICPA or similar association or organization that has a purpose of serving the interests of "accountants," as defined in Article 13. If an employee of such an organization served on a PAB, he or she would be obligated to serve both accountants and investors. While the interests of accountants and investors often are the same, they also may differ at times. To avoid real conflicts and the appearance of conflicts of interest, we have proposed that no employee of such an association or organization be a PAB board member and that there be a two-year period between working for such an organization and serving on a PAB. Because members of state boards of accountancy, which are state governmental agencies assigned the mission of protecting the public, would not face such conflicts, being a member or employee of a state board would not disqualify an individual from serving on a PAB.

of the work of these committees. Because the PAB would be more involved than the POB had been in evaluating each review report, determining the appropriateness of attendant recommendations for improvements in quality controls, directing reviews of larger firms, and performing similar functions, we believe that some minimal professional representation on the PAB is appropriate. We have taken the added precaution, in proposed rule 13-04(g)(5), however, of stating that only public board members, and not any accountant or retired accountant board members, may participate in any vote on whether to institute a disciplinary proceeding, or any vote on the findings or sanctions to be imposed in any such proceeding.

Under the proposed rule, the remainder of the PAB board members would be public members. A PAB may have as many public members as it believes are appropriate and necessary to fulfill its duties under Article 13. Public members should represent the interests of individual investors, institutional investors, and issuers. We anticipate that the public members may include, among others, former public officials, lawyers, bankers, institutional investors, securities industry executives, academics, economists, and business executives.

Each public member should have a background that permits him or her to make a contribution to the operations of the PAB. Having been, at some point in his or her career, an accountant who audited or reviewed financial statements that were filed with the Commission, or a partner or employee of an accounting firm that performed those functions, would not necessarily preclude a person from being a public member. To assure that such a member is, and is perceived as a public member, the proposed rule would require that he or she not have practiced as an accountant or been a partner or employee of an accounting firm for at least the ten-year period immediately before joining the PAB. We believe that an individual with such a prolonged separation from practice and from accounting firms, and with the intervening experiences gained in other professional endeavors, should not be presumed to be a representative of the accounting profession.

We request comment on the composition of the board. Should the proposed rule set the number of board members? If so, what number is appropriate to accomplish the goals of the rules? We also request comment on the board membership requirements.

Should we revise the criteria or ratios set forth above? Is the two-year parameter regarding employees of an accountant's professional organization appropriate? Would revising the criteria result in a board dominated by public members? Is the rule setting the ten-year parameter appropriate to ensure that the board has appropriate representation to fulfill the goals of the proposals? Are there other qualifications or restrictions on board members that ought to be addressed by Commission rule?

Does the rule appropriately define accountant members and public members or is some other definition more appropriate? We have indicated a person may be a "public" member of a PAB if he or she has not been an accountant within the last ten years. Is ten years too long? If a different period is appropriate, what period should it be?

We solicit comment on allowing a small number of accountants to be on a PAB. Should we require, rather than permit, that a certain percentage of board members be accountants? Whether mandatory or permissive, is the one-third standard appropriate, too high, or too low? Why? Is it appropriate to limit the number of accountants to three, no matter how large the board? Should there be no accountants permitted to be on a PAB, or is their expertise necessary for a PAB to carry out its mission?

Under proposed rule 13-04(b)(2) members would serve staggered terms in order to ensure continuity of operations. The proposed rule does not set the duration of terms or impose term limits on members. While the proposed rule leaves these matters to the PAB's discretion, we believe that three-year terms with some term limit, perhaps nine years, is appropriate. Such a term limit would allow new members with fresh ideas to make a contribution. We solicit comment on board terms. Should terms be staggered? Why or why not? Should the rule specify term limits and length of terms? If so, what would be an appropriate term and limit. For example, would a three-year term and nine-year limit further the goals of the rules?

Serving on a PAB would be a serious and time-consuming task. We have proposed in rule 13-03(b)(3) that a PAB's Chairman and Vice Chairman would be selected from among the public members and that at least one of these individuals would serve on a full-time basis. We envision that the remaining PAB members would devote approximately 20 to 25 percent of their professional time to PAB activities. A PAB's rules could provide for additional full-time members.

We solicit comment on the proposal to require that the Chairman and the Vice-Chairman be public board members and that at least one of them serve on a full-time basis. Is this requirement appropriate? Is it appropriate to limit the chairmanship and vice-chairmanship to the public members? Is it necessary or appropriate to accomplishing the purposes of a PAB that the Chairman or the Vice-Chairman be required to serve full time? Should more than one board member be required to serve full time, and if so, does it matter which board member(s)? Should we require the PAB to monitor and report to us on the time spent by PAB board members on PAB matters? Should requirements short of full-time service be placed on the percentage of time some or all the remaining board members devote to a PAB?

Another essential attribute for any entity applying to be a PAB, as reflected in proposed rule 13-03(b)(4), would be adequate staff and facilities, and the ability to hire consultants or advisers, necessary to carry out the purposes of Article 13. We anticipate that the professional staff of a PAB would include accountants with extensive experience in auditing and in the structure and operation of firms' quality control systems. These individuals must be able to assess the quality of audits and detect flaws in complicated quality control systems. They must be able to structure plans for reviewing firms' quality controls, put those plans into action, and conduct or supervise reviews that yield tangible improvements in the audit process. We also envision a PAB having a sufficient legal staff to facilitate effective disciplinary proceedings and provide sound advice on legal, procedural, and regulatory matters.

We solicit comment on the proper make-up of a PAB's staff. Should the proposed rules provide additional requirements regarding a PAB's staff or the means, capacity, and plans to hire that staff? Should a PAB be required to report to the Commission with respect to staff resource issues? If so, how often, and what should the reports entail? We have designed the composition of the board to provide assurance that a PAB would administer competently the proposed rules and that the public members would dominate the activities of a PAB. We request comment on all aspects of our proposed structure for the composition of a PAB, and on whether a PAB, as proposed, would be able to carry out its mandate effectively.

During our Roundtable discussions, Neil Lerner, a partner in the United Kingdom ("U.K.") KPMG accounting

firm, discussed the professional oversight system recently adopted in that country.<sup>90</sup> The UK system uses a series of boards, each having a majority of non-accountant members, to oversee the setting of professional standards and to discipline inappropriate professional conduct. We solicit comment on this and similar comprehensive regulatory approaches and the extent to which such systems may be the basis for the regulatory system used in the United States.

#### Charter and Bylaws

Proposed rule 13–04(c) sets certain requirements for a PAB's charter and bylaws. First, to limit the potential for excessive or unnecessary fees, proposed rule 13–04(c)(1) requires the charter and bylaws to provide that the entity will be a not-for-profit entity. Second, to assure that recusals, vacancies, or other factors do not result in a shift of voting power among the PAB members that would defeat public board member control of a PAB, proposed rule 13–04(c)(2) states that the entity's charter or bylaws must include quorum provisions ensuring that the public members can control the outcome of each vote by PAB members. Third, under proposed section 13–04(c)(3), in order to obtain Commission recognition, a PAB's charter and bylaws must provide that it will be subject to, and act in accordance with, Commission oversight as described in proposed section 13–04(i). Finally, proposed rule 13–04(c)(4) provides that a PAB's charter and bylaws must provide for immediate effectiveness of any changes that the Commission makes to the PAB's rules. As discussed below, proposed rule 13–04(i)(1) allows the Commission, by rule, to abrogate, add to, and delete from the rules of a PAB. In order for any such Commission rulemaking to operate efficiently, the PAB's charter or bylaws must make these changes effective with or without further action by the PAB.

We request comment on our proposals concerning a PAB's charter and bylaws. Should a PAB be required to be a not-for-profit entity? Could a for-profit entity achieve the purposes and goals of proposed Article 13 as well as, or better than, a not-for-profit entity? Are the other proposed requirements for a PAB's charter and bylaws necessary or appropriate to achieve the purposes and goals of proposed Article 13? Are there more appropriate and effective means for addressing these issues other than through a PAB's charter and bylaws? Are there other items that we should

require a PAB to have in its charter and bylaws?

#### Rules, Membership Requirements, Systems, and Procedures

Proposed rule 13–04(d) describes certain rules, membership requirements, systems, and procedures that a PAB must have in place to be recognized by the Commission. A PAB would need to have these requirements in place, at a minimum, in order to achieve the goals set forth in proposed section 13–03(c). These rules, requirements, systems, and procedures would accomplish the following:

*Enrollment Procedures.* Proposed rule 13–04(d)(1) would require a PAB to provide for membership enrollment procedures that: (1) minimize the administrative burden on individual accountants by maximizing the extent to which an accounting firm could satisfy the requirements on behalf of its individual accountants, and (2) require members and adjunct members to agree to be bound by a PAB's rules and membership requirements. The proposed rule allows a PAB latitude to determine the best approach to enrolling accountant-members, consistent with our requirement to minimize any burden on individual accountants. We expect that a PAB could adopt enrollment procedures that allow an accounting firm to enroll automatically all of its individual accountants by providing a PAB with a list of their names. This would eliminate any administrative burden on individual accountants. The proposed rule also reflects our intention that all members and adjunct members be made aware of their obligation to comply with a PAB's rules and membership requirements.

We solicit comment on our proposals concerning PAB enrollment procedures. Should our rules allow a PAB more or less flexibility in this area? Are there ways to reduce further administrative burden that could be specified in our rules? Should an entity that is an audit client of a PAB member accountant be required to file an application or other information with a PAB?

*Quality Control Systems.* Proposed rules 13–04(d)(2)–(4) concern a PAB's quality control system requirements for its members. Under proposed rule 13–04(d)(2), a PAB's rules would require member-accountants to maintain a system of quality controls for their accounting and auditing practices designed to meet requirements set or designated by a PAB. At a minimum, a PAB would set or designate quality control requirements that would encompass those described in proposed section 13–04(e), discussed below.

Under proposed rule 13–04(d)(3), a PAB would require its member-accountants to comply with their quality control systems in a way that provides reasonable assurance of conforming with professional standards. A PAB would also, under proposed rule 13–04(d)(4), develop and administer a continuing quality control review program for its members concerning accounting and auditing practices, and adherence to Commission and professional auditor independence requirements. The requirements for the quality control review program are set out in proposed rule 13–04(f), discussed below.

We solicit comments on the proposed rules concerning a PAB's requirements for members concerning quality control systems. Should a PAB have any other rules in place concerning its members' quality control systems?

*Retention of Documentation Related to Audits and Reviews.* It will be critical for a PAB to be able to review documents relating to audits performed and accordingly, it will be important for a PAB to have clear and effective requirements regarding record retention. Under proposed rule 13–04(d)(5), Commission recognition of a PAB would be conditioned on a PAB having in place rules, membership requirements, systems, or procedures that would direct each member firm to retain documentation related to the firm's audit and review engagements for a set period of time after completion of the engagement, and in accordance with such other policies as a PAB may establish. The records to be kept would include those required by the professional auditing literature,<sup>91</sup> and records that otherwise document the procedures performed and the resolution of material issues during the engagement. Record retention policies and the period of time for the records to be kept would be determined by a PAB under its rulemaking process.

We request comment on the requirement for a PAB to direct its member firms to retain certain documents. Are the categories of records the proposed rules would require a PAB to direct its members to retain appropriate? Should we be more specific in our rules with respect to either which documents must be retained or for how long? If so, please be specific about the types of documents and the length of time.

*Supplemental Reviews, Disciplinary Proceedings, and Dispute Resolution Procedures.* Under proposed rule 13–

<sup>90</sup> SEC Roundtables, *supra* note 8, at 40–41 (Mar. 6, 2002) (statement of Neil Lerner, Head of Risk Management (U.K.), KPMG).

<sup>91</sup> See generally, SAS No. 96, AU § 339 (as revised 2002).



04(d)(6), Commission recognition of a PAB would be conditioned on a PAB having rules and procedures for conducting supplemental reviews and disciplinary proceedings in accordance with the criteria set out in proposed rule 13-04(g), discussed below. Under proposed rule 13-04(d)(7), a PAB would need to provide procedures for requesting documents and testimony relevant to any PAB review or proceeding as described in proposed rules 13-04(f) and 13-04(g). We expect that a PAB will adopt rules and procedures in this area that are fair to all concerned while appropriately reflecting the need for strong enforcement mechanisms.

We solicit comments on our proposals regarding PAB procedures for disciplining and sanctioning member accountants, and resolving disputes with members and adjunct members. Should our rules provide more or less flexibility for a PAB in this area? Should we specify procedures for a PAB to resolve disputes with its members and adjunct members about fees, documents or testimony? Should we specify procedures, in addition to those described in proposed rule 13-04(g) below, for disciplining and sanctioning member accountants? If so, what specific procedures would be appropriate?

*Conflicts of Interest.* Under proposed rule 13-04(d)(8), a PAB would adopt appropriate policies to address any conflicts or potential conflicts of interest that may arise involving the PAB's board members, employees, contractors, and professional representatives. Even the appearance of a conflict of interest can damage investor confidence. Accordingly, we expect a PAB to devote careful attention to this area, and adopt policies that reassure investors that the PAB is acting in the public interest.

We solicit comments on our proposal concerning a PAB's conflict of interest policies. What conflicts of interest are likely to arise? Will a PAB be able to adopt policies to address these conflicts? Do we need to be concerned about an appearance of conflict? If so, should we revise the proposed rules to address better eliminating perceived conflicts of interest? Should we require a PAB to adopt specific rules in this area or should we allow a PAB to develop its own rules? What specific rules, if any, should we require?

*Funding for a PAB.* As noted above, a mandatory and continuous source of funds is critical to the independence and viability of a PAB. A PAB should not be dependent solely on the accounting profession for its funds or it may be viewed as beholden to, and

influenced by, the profession. Accordingly, under proposed rule 13-04(d)(9)(i), a PAB would impose fees on both member accounting firms and on registrants who are adjunct members, to fund the operations and administration of the PAB. A PAB would be encouraged to adopt schedules that provide for different classes of firms and registrants to pay different fees, such that the fees would not impose unfair or disproportionate burdens on any one firm or registrant. We also would expect that the fee structure would not result in the PAB being overly reliant on any class of firms or registrants for its revenues. The PAB would determine the most appropriate method for collecting the fees.

Each accounting firm, however, should bear the cost of its own quality control reviews. Proposed rule 13-04(d)(10), therefore, would provide for each firm to pay fees to the PAB, separate and apart from the fees determined according to the schedules discussed in the preceding paragraphs, that are sufficient for the PAB to recover its costs and expenses related to each quality control review of that firm pursuant to proposed rule 13-04(f). The review of a large firm's quality controls may cost in excess of a million dollars. It would be inappropriate, in our view, to have smaller or competing firms shoulder part of those costs.

We request comment on our proposals concerning funding for a PAB. Are there alternative funding mechanisms that would better achieve the goals and purposes for which a PAB would be established? The proposed rules permit a PAB to impose fees on its members and adjunct members, but the proposed rules do not describe in detail how such fees should be set or collected. Should we be more specific, or should such matters be left to the discretion of the PAB?

The proposed rules would require a PAB to impose fees on each member firm to reimburse it for the costs associated with the quality control review of the firm. Under our proposals, firms with 70 or fewer SEC Clients might undergo quality control reviews performed by other accounting firms. The PAB would impose fees on the reviewed firm related to the PAB's evaluation and oversight of the review. The reviewed firm, however, might pay the reviewer directly. Is the fee provision appropriate? Should each firm bear the approximate cost of its own quality control reviews, or should these costs be spread evenly among firms? Are there advantages or disadvantages to a system in which each firm bears the costs of its own reviews? Are there

particular approaches to billing and payment arrangements that would work best? Should our rules more specifically prescribe those arrangements? Should adjunct members contribute to the funding of these reviews?

*Funding for the FASB.* Proposed rule 13-04(d)(9)(ii) indicates that a PAB would collect fees sufficient not only to fund its own operations but also to fund the operation and administration of an accounting standards-setting body endorsed by the Commission as the primary source for generally accepted accounting principles. Today that body is the FASB.

The FASB currently receives most of its funding from two sources—sales of its publications and the receipt of voluntary donations.<sup>92</sup> Because accounting firms and corporations purchase a significant portion of FASB's publications and make the majority of the voluntary donations to the FASB, these two groups have significant influence over the funds available to the FASB. By reducing donations, or by reducing the volume of their purchases, they have the potential to impact the funds available to the FASB.

During debates of controversial accounting proposals, perceptions may arise that a corporation or accounting firm, or groups of corporations or firms, could use donations and sales volume to influence the FASB's decisions on substantive accounting issues.<sup>93</sup> To remove such possibilities, and to increase the stature, neutrality, and perceived independence of the FASB, we have proposed that the FASB, through fees paid to a PAB, have a mandatory and continuous source of funds.

Accordingly, we anticipate that a PAB would receive a proposed budget from the FASB and the PAB would include the amount required to fund the FASB in determining the fees to be collected from accounting firm members and registrant-adjunct members. After collection, a PAB would pass those funds to the FASB.<sup>94</sup> We anticipate that the Financial Accounting Foundation ("FAF"), which is a private sector body

<sup>92</sup> Financial Accounting Foundation, *High-Quality Financial Reporting: 2001 Annual Report*, at 29, which indicates FASB received net contributions of \$5,113,000 and subscription and publication sales of \$14,818,000; its direct costs of sales was \$1,586,000.

<sup>93</sup> See, e.g., Stephen Barr, *FASB Under Siege*, CFO Magazine, Sept. 1994, at 34, 46; Dean Foust, *It's Time to Free the FASB Seven*, Bus. Wk., May 3, 1993, at 144.

<sup>94</sup> In the event that more than one entity obtains Commission recognition as a PAB, as we anticipate that the FASB would receive funding through each PAB according to a formula that takes fair account of any significant difference in the size of the various PAB's membership.

comprised of representatives of the business, professional, and academic communities that selects FASB members and handles financial matters for the FASB,<sup>95</sup> would continue to play a significant oversight role in determining the FASB's budget.<sup>96</sup>

We request comment on our proposal concerning funding for the FASB. Should fees collected by a PAB be used to fund the FASB? How would an appropriate amount of fees for such a purpose be determined? Is it sufficient to rely on the FAF to assist in the preparation of the FASB's budget or should the FASB be required to submit an annual budget to the PAB? Our proposal anticipates full funding for the FASB, with the FASB appropriately reducing or eliminating the cost of its publications. Should the FASB, however, continue to generate revenues from the sale of its publications, and replace only the donations it receives with fees collected by a PAB? Would a PAB collect fees to fund the FASB in a different manner than the fees used to fund the PAB's operations and, if so, how should the fees to fund the FASB be collected? Should registrants and accounting firms be required to join the FAF so that the FAF may directly impose fees to fund the FASB?

In addition to raising funds for the FASB, the FAF raises funds for the GASB, which sets financial accounting and reporting standards for state and local governmental entities. Financial reports prepared under GASB may be the basis for investment, credit, and regulatory decisions. Because GASB has not been in existence as long as FASB, more of its funding is derived from private contributions. Costs associated with GASB are discussed in the Cost-Benefit Section of this Release. Should a PAB collect fees to fund GASB as well as FASB?

*Fair Dispute Resolution Procedures and Notices of Delinquencies.* Under proposed rule 13-04(d)(11), Commission recognition of a PAB would be conditioned on the PAB having fair procedures for disciplining and sanctioning accountants and for resolving disputes with member accountants and adjunct members concerning fees, document requests and requests for testimony. As discussed

above in connection with the definition of "delinquent," we would expect a PAB to take very seriously the need for fair procedures to resolve any good faith disputes.

The proposed rule also specifies the need for a PAB to have procedures for providing appropriate notice to member accountants, adjunct members, the Commission, and the public, of any action that could result, or has resulted, in suspension or bar of a member accountant, or any other loss of good standing by a member accountant or an adjunct member. The PAB's rules and procedures should be designed to balance a member or adjunct member's legitimate interest in keeping certain disputes nonpublic (such as may occur during a nonpublic PAB supplemental review) with the need to provide the public, including an accountant's audit clients, with sufficient notice of an accountant's potential loss of good standing before actually revoking good standing. In addition, it is pursuant to this proposed rule that a PAB must have procedures for providing actual notice that a member accountant or adjunct member has been determined to be delinquent.

We request comments on our proposals regarding these notices. Should the proposed rules be more specific about when these notices would be required, or about the content of the notices? If so, when should the notices be required? For example, would it be appropriate to require a 90-day notice period before a PAB makes a public determination that a member or adjunct member is delinquent? What should the notices say?

*Professional Standards.* For a PAB to be effective, it must be able to address not only personnel and systems failures in accounting firms, it must be able to address poor quality or vague standards that lead to deficient audits. When a PAB sees a need for new or revised standards, it must have a means to assure those standards are adopted and that other standard-setters, to the extent appropriate, conform their standards to facilitate the correction of the problem. Accordingly, a PAB, under proposed rule 13-04(d)(12), would either set, or designate private sector bodies to set, audit, quality control, and ethics standards. If it chooses to designate private sector bodies to set such standards, then a PAB would oversee the designated bodies by attending meetings, commenting on proposed standards, meeting as needed with each body, and, requesting that items be added to the private sector standard-setters' agendas and notifying the

Commission when any such request is made.

Under proposed rule 13-04(d)(13), a PAB would also request that matters be added to the agendas of private sector bodies that set accounting or independence standards, and similarly notify the Commission of each such request. Under proposed rule 13-04(d)(14), a PAB also would sponsor meetings with and among private sector standard-setting bodies to coordinate their activities and to promote the sharing of information and effective communications.<sup>97</sup> These meetings would include not only the bodies involved in setting audit, quality control, and ethics standards, but also accounting standard-setting bodies, the Commission staff, and any other persons that the PAB considers appropriate.

We request comments on our proposals regarding professional standards. What is the proper role of a PAB in standard setting? Should a PAB have the ability to set standards? Should it have the ability to designate which bodies would be considered authoritative? We request comment on the proposed role of a PAB in contributing to the agenda of private sector bodies that set accounting or independence standards and in coordinating among standard-setting bodies. Are these appropriate and useful roles for a PAB to play in satisfying the goals and purposes sought through proposed Article 13? Are there more specific or additional roles that a PAB ought to play in this regard? Should the Commission approve the bodies designated by a PAB before those bodies are considered authoritative?

*Open and Deliberative Process.* A PAB's process for amending governing documents, rules, membership requirements, and procedures would include an open and deliberative rulemaking process with open meetings and publication for public comment of draft rules, requirements and procedures. Allowing for public input would enhance public confidence in a PAB's process, and improve the quality of a PAB's governing documents, rules, membership requirements, and procedures. Accordingly, we have addressed the need for such processes in proposed rule 13-04(d)(15).

We request comment on the importance of an open and deliberative rulemaking process for a PAB. What

<sup>95</sup> The FAF is comprised of 16 Trustees representing a broad range of professional backgrounds. The FAF currently has responsibilities for FASB and the Government Accounting Standards Board ("GASB"), and for their Advisory Councils, including oversight of the standard-setting process, selection of FASB and GASB members, and arrangements for financing.

<sup>96</sup> Further discussion of the history of the Commission's endorsement and oversight of FASB can be found in Appendix B.

<sup>97</sup> See, e.g., The Panel on Audit Effectiveness, *Report and Recommendations*, at 141 (Aug. 31, 2000), which emphasizes the need for effective communications among standard-setting bodies and the bodies involved in disciplining accountants and conducting reviews of accounting firms' quality control systems.

goals does it serve in the context of a PAB? Should our rules specify the types of procedures that a PAB should employ in rulemaking, or is this better left to a PAB to decide? What matters should a PAB be required to address only through an open process? Are there circumstances we should provide for under which issues concerning the amendment of governing documents, rules, membership requirements, and procedures should be handled other than through such open processes?

**Full Faith and Credit.** Under proposed rule 13–04(d)(16), a PAB would give “full faith and credit” to the sanctions and good standing requirements of another PAB. This would be necessary, if more than one PAB is formed, to prevent an accountant from attempting to avoid a sanction by one PAB by resigning and joining a different PAB. This provision also notes that a registrant may not avoid a finding that it is in violation of a PAB’s good standing requirements (due to not paying fees assessed by the PAB or not providing requested testimony or documents) simply by firing its current accountant and engaging another accountant that is a member of a different PAB. In such circumstances, the new PAB would consider the registrant to be not in good standing until the registrant remedied the nonpayment of fees or delinquency in providing testimony or documents.

We request comment on the proposed requirement to extend full faith and credit to another PAB. How would this requirement work in practice? Will a requirement to extend full faith and credit prevent attempts to avoid sanction by resigning from one PAB and joining a different PAB? Should our rules be more specific?

**Training.** A key to maintaining professional competence is continued training throughout an accountant’s career. Business and financial transactions, as well as audit practices, change with ever-increasing speed. Accountants need to be able to keep abreast of these developments and adapt their skills. Under proposed rule 13–04(d)(17), therefore, we condition the Commission’s recognition of a PAB on the PAB providing training for, or imposing appropriate training requirements on, its member accountants in matters relating to accounting, auditing, attestation, assurance, ethics, independence, and quality controls. A training requirement should increase investor confidence that audits are being performed effectively and competently.

We request comment on the proposed requirement that a PAB provide or

require training. Should we specify the particulars of a required training program? What would be the components of such a program? Should our proposed rules require a specific amount of training per year? How much training should be required?

**Other Duties or Requirements.** Under proposed rule 13–04(d)(18), a PAB’s rules, membership requirements, systems, and procedures would specify that the PAB would perform such other duties or functions as the Commission determines are necessary or appropriate in the public interest or for the protection of investors and to carry out the purposes of proposed Article 13. This provision would allow the Commission to oversee effectively a PAB’s activities to make sure that the PAB is operating in accordance with the proposed rules, and would allow for the possibility of marshalling a PAB’s resources for special projects that fall within its realm of responsibility. For example, in the past ten years, we asked the former POB to study accounting firms’ quality control systems related to auditor independence, recent changes in audit techniques and practices, and various issues related to professionalism and independence.<sup>98</sup> We solicit comment on this provision.

More generally, we solicit comment on these rules and requirements. Should we include other requirements necessary for the proper functioning of a PAB as we describe it? Are any of the proposed requirements too onerous? Why?

#### Quality Control Requirements

Proposed rule 13–04(e) conditions Commission recognition of a PAB on the PAB ensuring that its member accountants maintain a quality control system designed to meet the requirements of quality controls set or designated as authoritative by the PAB. These controls should encompass at least the current AICPA quality control elements: independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring.<sup>99</sup> In addition, the proposed rule conditions Commission recognition on a PAB requiring its members to maintain certain specific quality controls, many of which are current SECPS membership requirements.<sup>100</sup> A PAB

may supplement or otherwise modify the quality control elements and specific requirements with other elements and requirements it deems appropriate.

“Independence, integrity, and objectivity” policies address the firm’s relationships with its clients. “Personnel management” refers to the criteria for the hiring, development, continuing education, advancement, and assignment of personnel. The element related to the “acceptance and continuance of clients and engagements” is designed to provide reasonable assurance that the likelihood of associating with a client’s management that lacks integrity is minimized. “Engagement performance” policies are intended to provide reasonable assurance that the firm complies with applicable professional standards and regulatory requirements. And “monitoring” involves an ongoing evaluation of the relevance of the firm’s policies, the appropriateness of the firm’s guidance materials and practice aids, the effectiveness of professional development activities, and compliance with the firm’s policies and procedures.<sup>101</sup> We believe that these elements continue to be essential to high quality accounting and auditing practice and should continue to be required.

We request comment on conditioning Commission recognition on a PAB requiring that its member accountants maintain a quality control system. We stated that the controls should encompass at least the current AICPA elements and certain SECPS membership requirements. Are these elements appropriate to address the concerns discussed in the release? Are there other elements that we should require a PAB to include as part of its quality control system?

The specific quality controls that should continue to guide accounting firms’ accounting and auditing practices include:

- Rotating the partner in charge of an audit engagement at least once every seven years;<sup>102</sup>
- Having a second-partner (one other than the partner in charge of the audit engagement) independently review the audit report and the financial statements,<sup>103</sup> unless the PAB authorizes alternative procedures where

<sup>98</sup> These projects are noted in Appendix A.

<sup>99</sup> AICPA, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*, ¶ 7, Quality Control (“QC”) § 20.07.

<sup>100</sup> See generally, SECPS, *Requirements of Members*, items, e, f, h, i, k, m, n, o, and p. The membership requirements are available online at

<http://www.aicpa.org/members/div/secps/require.htm>.

<sup>101</sup> See *supra* note 99, QC § 20.07–20.20 (description of each quality control element).

<sup>102</sup> SECPS, *Requirements of Members*, at item e.

<sup>103</sup> *Id.* at item f.

this requirement cannot be met because of the size of the firm;

- Ensuring policies and procedures are in place to comply with auditor independence requirements and to refrain from providing to audit clients consulting services that are inconsistent with § 210.2-01 and conducting public opinion polls and merger and acquisition assistance for a finder's fee;<sup>104</sup>

- Reporting to the audit client and the SEC when the firm resigns, declines to stand for reelection, or is dismissed;<sup>105</sup>

- Seeking to have foreign associated firms adopt policies and procedures consistent with the objectives of the proposed rules, and notifying the Commission when any such firms have done so;<sup>106</sup> and

- Ensuring the firm has policies and procedures for reporting litigation or government investigations or proceedings to the PAB,<sup>107</sup> with a copy of the report to the Commission's Office of the Chief Accountant.

We request comment on each of these items. Is a requirement to rotate a partner every seven years, for example, the appropriate time frame? Should a PAB be permitted to make any exceptions to these requirements in some cases? If so, under what circumstances?

In addition to the current SECPS membership requirements, other practices currently enhance investors' confidence and contribute to improved audit quality. Under proposed rule 13-04(e), Commission recognition of a PAB depends on the PAB requiring its members' quality control systems to encompass these practices as well. For example, proposed rule 13-04(e)(4) essentially restates the requirement in Independence Standard No. 1 regarding communications on auditor independence issues between an accountant and the audit committee of its audit client.<sup>108</sup>

Another example of a beneficial practice is maintaining a central office

function that has expertise in accounting and financial reporting matters, and having policies and procedures in place for: (1) Engagement partners and others to consult with that office, and (2) the resolution of differences of opinions between that office and engagement partners. Proposed rule 13-04(e)(8) would condition Commission recognition of a PAB on the PAB ensuring that member firms maintain such a central office function, but a PAB could authorize alternative procedures for firms that could not meet this requirement because of their size. We solicit comment on the central office function requirement. Would this requirement place a burden on those firms that do not already maintain a central office function? Would conditioning recognition on the maintenance of a central office function pose any competitive concerns?

Finally, proposed rule 13-04(e)(9) would condition Commission recognition of a PAB on the PAB ensuring that its members incorporate many of the procedures discussed by the Independence Standards Board in Independence Standard No. 3, *Employment with Audit Clients*.<sup>109</sup> This standard requires an accounting firm, when an audit client employs a former firm professional, to take steps to eliminate the risk that the firm's former partner or employee could, by reason of his or her knowledge of or relationships with the firm, adversely influence the quality or effectiveness of the audit.<sup>110</sup>

We request comment on the quality control elements and specific requirements we have included in the proposed rule. Should we require these items, or should we defer to a PAB's discretion to devise quality control elements and requirements or to designate another entity's as authoritative? If they should be retained, should any be omitted or should additional procedures be added? Which ones? For example, should all partners who participate in a portion of the audit of a registrant's financial statements be rotated periodically? Are there other circumstances when we should require reporting to the audit client, a PAB, and/or the SEC? What are they? Should the Commission provide greater or lesser direction regarding the content of requirements set or adopted by a PAB?

#### Quality Control Review Program

In section 13-04(f), we propose to build on the most successful parts of the

SECPS's peer review process and membership requirements to create a stronger, more diligent and independent system. Proposed rule 13-04(f) conditions Commission recognition of a PAB on the PAB having a continuing program for the review and inspection of member accountants' compliance with the PAB's rules and membership requirements and professional standards.

The frequency of the reviews of a firm's quality control system under proposed rule 13-04(f)(1) would vary based on the number of the firm's SEC clients. For each member firm with more than 70 SEC clients, or such other number of SEC clients as the PAB may determine, the proposed rule would require a PAB to conduct an annual review of the firm's quality control system. For all other member firms, a review would be conducted at least once every three years.

According to a recent computer run of SECPS members, ten accounting firms have more than 70 SEC clients.<sup>111</sup> We have chosen 70 SEC clients for the dividing line to ensure that those accountants who audit the vast majority of registrants will be subject to very frequent scrutiny by a PAB. We recognize that the number of firms with more or less than 70 SEC clients, and the need to review more or fewer firms on an annual basis, may change over time. Proposed rule 13-04(f)(1), therefore, would provide a PAB with the discretion to change the number of SEC clients that would trigger an annual, as opposed to a triennial, review.

Should a PAB conduct reviews more or less often than annually for the larger firms? Will triennial reviews for small firms meet the goals of the proposed rules? Should a PAB have the discretion to alter these frequency requirements based on experience over time with the review process? If so, in what way, if any, should that discretion be guided by Commission rules?

We also request comment on whether 70 SEC clients is the appropriate trigger for an annual review or whether a larger or smaller number of SEC clients would be more appropriate. Additionally, we request comment on the proposal to provide a PAB with discretion to alter the 70 SEC client trigger/standard. Should a PAB have that discretion? If it does not, how should developments over time and a PAB's experience with the review process be factored into or accounted for in adjusting the trigger, as

<sup>104</sup> *Id.* at item h and o.

<sup>105</sup> *Id.* at item m.

<sup>106</sup> *Id.* at item n. As discussed elsewhere in this release, foreign accountants would be exempt from the coverage of the proposed rules. The provisions in this section is intended only to continue current practices, under the SECPS membership requirements, of encouraging foreign firms to improve their quality control systems.

<sup>107</sup> *Id.* at items k and p.

<sup>108</sup> Independence Standards Board, *Independence Discussions with Audit Committees*, Independence Standard No. 1 (Jan. 1999), which requires the auditor to disclose to the audit committee, in writing, relationships that the auditor believes may reasonably be thought to bear on auditor independence, confirm in the letter its independence, and discuss its independence with the audit committee.

<sup>109</sup> See Independence Standards Board, *Employment with Audit Clients*, Independence Standards No. 3 (July 2000).

<sup>110</sup> *Id.*

<sup>111</sup> The same data, derived from a list obtained from the SECPS, indicates that ten firms have between 30 and 75 SEC clients and approximately 800 firms have fewer than 30 SEC clients.

may be appropriate? If a PAB is granted discretion to change the trigger, are there factors the Commission should identify to guide the exercise of that discretion?

Proposed rule 13-04(f)(2) would permit a PAB to direct its member firms to make and keep records that are necessary for the conduct of the reviews. Proposed rule 13-04(f)(3) would make clear our expectation that a PAB would establish the policies and procedures for conducting reviews, establish reporting requirements, and maintain public files. Under proposed rule 13-04(f)(4), a PAB would monitor each review to ensure that it is conducted in a fair and impartial manner and that appropriate procedures are recommended and implemented to correct any noted deficiencies in a timely and effective manner.

We request comment on all aspects of our proposals regarding quality control reviews, including on the elements of a strong quality control review program. How can a PAB best assess compliance of its members with rules of a PAB and with professional standards? How can a PAB best assess compliance of individual accountants associated with a firm?

If a PAB program would be compared to the peer review program that currently is conducted under the auspices of the AICPA, we would expect that the PAB and its staff would perform the functions related to peer reviews that currently are performed by the Peer Review Committee,<sup>112</sup> the SECPS Executive Committee,<sup>113</sup> and until recently the POB and the POB staff,<sup>114</sup>

<sup>112</sup> The Peer Review Committee administers the peer review program, establishes standards for conducting peer reviews, establishes standards for reports on peer reviews and publication of such reports, requests the SECPS Executive Committee to appoint a hearing panel when it believes that sanctions should be imposed on a member firm for failure to comply with membership requirements, keeps records of peer reviews, and establishes and maintains a public file for each member firm, which includes the firm's three most recent annual reports, the latest peer review report, the reviewer's letter of comments, and the firm's response. See AICPA, *Governing Bodies* at: <http://www.aicpa.org/members/div/secps/bodies/index.htm>.

<sup>113</sup> The SECPS Executive Committee, among other things, establishes requirements for membership in the SECPS and determines sanctions to be imposed on member firms for failure to comply with the SECPS's membership requirements, ordinarily through the appointment of hearing and appeals panels. *Id.*

<sup>114</sup> The POB and the POB staff, among other things, monitored and evaluated the effectiveness of the Peer Review Committee and the SECPS Executive Committee and determined whether the Peer Review Committee was ascertaining that firms were taking appropriate action as a result of findings during peer reviews. *Id.*

to the extent those functions are deemed necessary by a PAB.

Under proposed rules 13-04(f)(5) a PAB would direct and make all key decisions related to each review of a firm that has over 70 SEC clients, or such other number of SEC clients as the PAB may determine. For firms with 70 or fewer SEC clients, a PAB may permit the reviews to be conducted by non-PAB staff, but only if the PAB: (1) Approves the review program; (2) establishes policies and procedures for the reviews as well as for reporting the results of the reviews; (3) maintains public files related to the reviews; (4) monitors the program to insure that reviews are conducted in a thorough and impartial manner; and (5) evaluates each review to gain assurance that appropriate procedures are being recommended and implemented to correct any noted deficiencies in a timely and effective manner.

We request comment on whether a PAB should be permitted to use approved review programs. The five items listed should help to make sure that such programs operate effectively. Are there any other requirements that should be added to this list before a PAB may permit reviews under a review program? If review under a program is permitted, should a PAB, as part of its oversight of such a program, have control or veto power over the reviewer?

Under proposed rule 13-04(f)(5)(i), in performing a PAB-directed review, the PAB may engage accountants from one or more non-associated firms to work on the review. As noted above, however, all key decisions must be made by the PAB. We are proposing to allow the PAB to engage such accountants to assist in doing the "leg work" of the reviews, so that a PAB may decide whether to hire a larger permanent staff or to contract for additional support on reviews as needed. Any accountants engaged to assist the PAB in conducting the reviews would perform only assigned functions and be supervised by the PAB or its staff.

Should a PAB be permitted to engage accountants to work on a review? If so, what is the scope of functions that accountants engaged to assist a PAB in conducting reviews should be permitted to perform? Should there be other limitations or requirements on the accountants that may be engaged to assist a PAB in conducting a review? Would it be practical, and would a PAB be able to obtain the necessary expertise, if it had to conduct all or a significant portion of reviews exclusively with its own staff? Should a PAB direct the reviews, and make all key decisions for all reviews? In a PAB-

directed review, should a PAB be permitted to engage, on a contract basis, employees of firms that are not affiliated with the firm being reviewed to do the "leg work" on the review? We have proposed that firms with 70 or fewer SEC clients may have quality control reviews conducted under a review program approved by a PAB. Should firm-on-firm reviews be allowed? If firm-on-firm peer reviews are allowed, should a PAB, as part of its oversight of such a program, have veto power over a firm's selection of its reviewer? Should these reviews be conducted by teams of persons from one accounting firm or should the teams include members from several firms? What are the advantages and disadvantages of either team composition? Should firms employ staff members dedicated, at least on a part-time basis, to PAB quality control reviews?

Proposed rule 13-04(f)(6) provides that a PAB or approved reviewer would examine various offices and personnel within the firm. It also would require a PAB or reviewer to determine whether the firm's quality control system is appropriate, whether adequate documentation and communication of quality control policies and procedures exists within the firm, and whether those policies and procedures provide reasonable assurance of compliance with the Commission's rules, the PAB's rules and membership requirements, and professional standards. Under proposed rule 13-04(f)(7), a PAB or reviewer would prepare a report of its findings and comments during each review. Each report and any response provided by the reviewed firm would be available to the public.

We solicit comments on the appropriate scope of a review and the type of report and access to the report that should be established by the rules.

#### Supplemental Reviews and Disciplinary Proceedings

In proposed rule 13-04(g) we have created the framework for a disciplinary process that for the first time would add teeth to the quality control review process. Under this proposal, the PAB could suspend or bar an individual or firm from being a member of a PAB or impose other remedial or disciplinary sanctions, as it believes appropriate. Such a proceeding might be based on an individual accountant's incompetent or unethical conduct, other acts or omissions that constitute a failure to comply with professional standards, or for violations of the PAB's rules or membership requirements. A proceeding against a firm might be based on the issuance of an adverse

review report, which indicates that the firm's quality controls, or compliance with those controls, are deficient and fail to provide reasonable assurance that the firm is complying with professional standards during its audit, review, or attest engagements. A PAB could also institute disciplinary proceedings against a firm or an individual for conduct that comes to the attention of a PAB other than through the quality control review.

Proposed rule 13-04(g)(1) conditions Commission recognition of a PAB on the PAB having rules, membership requirements, systems, and procedures, incorporating the criteria described in this section, pursuant to which it could institute public disciplinary proceedings to determine whether an accountant has violated PAB rules or membership requirements, or professional standards, and to impose sanctions. Prior to making a determination to institute a disciplinary proceeding, under proposed rule 13-04(g)(1)(ii) a PAB may, on the basis of information suggesting such a violation, engage in a nonpublic "supplemental review" process of gathering information relevant to its determination of whether to institute a disciplinary proceeding.

The supplemental review process would be an important part of the PAB's mission. We would expect a PAB to pursue a supplemental review on the basis of any information suggesting the possibility of the type of violation described above, whether that information comes to a PAB through a routine quality control review or otherwise. Some supplemental reviews might be very brief, with PAB staff satisfying itself in the course of a single interview that there is no basis for inquiring further, while other supplemental reviews could be complex, requiring careful consideration of a large amount of information to make a responsible decision about whether to institute a disciplinary proceeding. Proposed rule 13-04(g)(4) provides that a PAB may request relevant testimony and documents from any person in connection with a supplemental review or a disciplinary proceeding.

We request comment on the proposed supplementary review and disciplinary mechanisms. Under what circumstances should a PAB exercise this power? Should a PAB have the power to suspend or bar an individual or firm from being a PAB member? Should the rules set forth detailed requirements regarding the procedures that a PAB should employ before exercising disciplinary powers? What procedures,

limitations, and controls should apply to a PAB's exercise of its disciplinary powers? Should the rule provide more specific limits on the circumstances in which a PAB may pursue a supplemental review?

If a PAB becomes aware of information indicating that a violation of the securities laws has, or is likely to have, occurred, then under proposed rule 13-04(g)(2) the PAB would notify the Commission. As noted above, we intend to continue to address instances of violations of the securities laws and other conduct through our enforcement efforts, including enforcement of Rule 102(e) of our Rules of Practice. Violations of the securities laws and other actionable conduct should not go unaddressed because they are detected during a quality control review as opposed to coming to light through another means. While we recognize that some may fear that such a referral procedure could have a chilling effect on the review process, to provide otherwise would be contrary to our mandate under the securities laws. In light of the balance between these interests, we request comment on whether we should require that a PAB notify the Commission of information indicating that a violation of the securities laws has or is likely to have occurred. Would this referral procedure affect the review process? If so, how?

Further, to ensure that there is not unnecessary duplication of effort or burden on a party, and to retain the Commission's control over the enforcement of the securities laws, we propose that a PAB could only institute a disciplinary proceeding regarding that information after notifying and consulting with the Commission. We solicit comment on whether the Commission should prohibit a PAB's institution of a disciplinary proceeding in this manner. Are there alternative ways to achieve the purposes of this limitation? Should a PAB have broader discretion and disciplinary powers to conduct proceedings related to violations of the securities laws?

Under proposed rule 13-04(g)(3), a PAB must establish fair procedures for supplemental reviews and disciplinary proceedings. The rule also would require a PAB's disciplinary proceeding to be public unless otherwise ordered by the PAB with the prior approval of the Commission. We intend for a PAB's disciplinary proceedings to be open and transparent to the same extent that our Rule 102(e) proceedings are open to the public.<sup>115</sup>

<sup>115</sup> See 17 CFR 201.102(e)(7). In 1988, the Commission amended Rule 102(e) to state that

We request comment on the requirement that a PAB establish procedures for disciplinary proceedings. Should our rules be more specific with respect to the procedures a PAB must establish, such as specifically providing for appropriate burdens of proof or evidentiary rules? We request comment on the ability of a PAB to institute disciplinary proceedings and supplemental reviews, and on the procedures proposed for those proceedings and reviews. Under the proposal, disciplinary proceedings would be public. Are there reasons that all disciplinary proceedings, certain categories of disciplinary proceedings, or certain portions of disciplinary proceedings should not be public, or as to which a PAB should have discretion to make them non-public? Is providing a PAB discretion to close a disciplinary proceeding, but only with prior Commission approval, an appropriate response to these situations, given that it may not be possible to foresee all possible contingencies?

We are not proposing to prescribe the details of the hearing process. A PAB, if it chooses, may have independent, non-accountant hearing officers conduct a hearing and recommend findings and sanctions to the PAB, in a manner not dissimilar to the process used by the NASD. Alternatively, it may require a panel of PAB members, with the advice of legal counsel, to conduct the hearings, or it may adopt rules and procedures for other suitable proceedings. Should we require a particular process in this area?

At a minimum, however, under proposed rule 13-04(g)(3), a PAB should provide its members with procedural safeguards similar to those required by statute in proceedings conducted by the securities exchanges and the NASD. These include notice of specific charges, an opportunity to defend against the charges, a record of the proceedings, and an explanation of the grounds for any sanction imposed.<sup>116</sup> As noted above, we believe that to have a credible process and protect the interests of both investors and accountants, these proceedings should be public to the

proceedings shall be public unless the Commission otherwise directs, and stated that the reasons supporting public proceedings against accountants include that disciplinary proceedings against broker-dealers and other market professionals are public, that private proceedings create an incentive for delay, that there is considerable public and professional interest in such proceedings, and that public proceedings are more favored in the law than are closed proceedings. See *Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission*, Release No. 33-6783 (July 7, 1988), 53 FR 26427 (July 13, 1988).

<sup>116</sup> See, e.g., 15 U.S.C. 78o-3(h).

same extent as our Rule 102(e) proceedings.

We request comment on which safeguards, if any, a PAB should provide to its members. Are there additional safeguards that any final rules should require a PAB to provide? Are there safeguards that we propose that are unnecessary and would impede a PAB's ability to accomplish the goals and purposes of Article 13? Should the Commission provide more guidance or detail regarding the safeguards it proposes or may adopt in this proposed rule?

Under proposed rule 13-04(g)(4), Commission recognition of a PAB is also conditioned on the PAB having rules pursuant to which it may request that any person provide documents or testimony relevant to any supplemental reviews or disciplinary proceeding. We have not proposed any provisions pursuant to which a PAB could require production or testimony from anyone who is not a member or adjunct member of the PAB.

Are there appropriate mechanisms that could be included in the rule to increase the PAB's ability to obtain documents and testimony? Should the rule limit the circumstances under which, or the methods by which, a PAB should be permitted to seek documents and testimony?

Proposed rule 13-04(g)(5) states that PAB board members who are not public members would not vote on any disciplinary matters (but could be consulted in connection with supplemental reviews and disciplinary proceedings). Placing the outcome of disciplinary matters solely in the hands of representatives of investors and issuers would serve to enhance investor confidence that their interests are being protected.

Is this proposed restriction on voting in disciplinary matters to the public board members appropriate in light of the importance of assuring investor confidence in these proceedings? Are there circumstances when the accountant board members should be able to vote? Should further or other limitations be placed on the participation of accountant board members with regard to disciplinary proceedings or supplemental reviews? For example, should consultation be prohibited as well? If so, why?

Under proposed rule 13-04(g)(6), if a PAB finds in a disciplinary proceeding that an accountant has violated rules or membership requirements of a PAB or professional standards, it could, among other sanctions, revoke or suspend the accountant's membership in, or expel the accountant from, the PAB; impose

limitations on an accountant's activities, including requiring resignation from a specific audit, review, or attest engagement; suspend or bar an accountant from participating in any SEC audit, review, or attest engagement; impose fines and censures; and impose any other appropriate sanction.

The Commission requests comment on whether these are appropriate sanctions. Should our rules be more or less specific with respect to the sanctions and remedial actions a PAB could take? If so, how?

To provide heightened transparency in the disciplinary process, proposed rule 13-04(g)(7) would provide for a PAB to issue a public written report whenever it imposes a sanction. Copies of the report would be provided to the Commission and to any state or foreign financial regulatory authorities, with which the individual or firm is licensed, registered, or certified to practice public accounting. Each report would name the accountant being sanctioned, describe the acts or omissions on which the sanction is based, describe the nature of the sanction, and contain such other information as the PAB deems appropriate. We request comment on the persons to whom the report should be sent, whether it should be public, and what information it should contain. In addition, we solicit comment on whether public reports, either on a case-by-case basis or otherwise, should be provided when a PAB determines that no sanction should be imposed, and, if so, what those reports ought to include.

Under proposed rule 13-04(g)(8), if a PAB is unable to complete a proceeding because of the refusal of any person to provide testimony or documents or otherwise to cooperate with the PAB, then the PAB would report that refusal to the Commission. Further, where the uncooperative party is a registrant, the PAB would additionally report the refusal to any market or exchange on which that registrant's securities are traded. Under this proposed rule, a PAB also may refer any other matter to the Commission that it deems appropriate.

We solicit comments on the reporting and referral provisions in proposed rule 13-04(g)(8). Among other matters, should the Commission provide guidance or details regarding the timing and content of those reports and referrals. Are there other circumstances when a PAB should report to the Commission or to an exchange or market on which a registrant's securities are traded?

Proposed rule 13-04(g)(9) addresses the situation where a firm employs a person who is subject to a PAB sanction, order, or ruling. Because many

accounting firms provide diverse and varied services, it is possible for a firm to retain an individual to perform services that are unrelated to audits, reviews, or attest services for Commission registrants. Under this provision, however, the firm would notify the PAB of its relationship with the sanctioned individual and undertake procedures to make sure the terms of the sanction, order, or ruling are not violated. We request comment on these proposed requirements. Is it necessary or appropriate to the accomplishment of the goals and purposes of Article 13 for a member accounting firm to provide notice if the individual is not going to perform any audit, review, or attest services for registrants? Should the requirement to provide notice take into account whether the sanctioned person would perform services unrelated to audits of Commission registrants? Should the firm's requirement to notify a PAB of its relationship with the sanctioned person be a one-time or continuous requirement?

Rule 102(e)(2) of the Commission's Rules of Practice states that any person whose license to practice as an accountant has been revoked or suspended in any state, and any person who has been convicted of a felony or a misdemeanor involving moral turpitude, shall be forthwith suspended from appearing or practicing before the Commission.<sup>117</sup> Should proposed rule 13-04(g)(9), if adopted, include a provision that any person barred, suspended, or expelled from membership in a PAB shall be forthwith suspended from appearing or practicing before the Commission? Should we include such a provision in Rule 102(e)(2)?

#### Public Reporting

To facilitate our oversight and to provide transparency regarding a PAB's operations and processes, we would encourage a PAB to make as much information available on a "real-time" basis as possible. Under proposed rule 13-04(h), a PAB would report to the Commission and the public at least annually, and where practicable on a current basis:

- A description of its quality control review and disciplinary activities;
- Annual audited financial statements;
- An explanation of fees and charges imposed on member accountants and adjunct members;
- A summary of issues discussed in the PAB-sponsored meetings with, or in

<sup>117</sup> 17 CFR 201.102(e)(2).



connection with its oversight of, private sector standard-setting bodies;

- A list of matters referred to each private sector standard-setter that were not placed on the standard-setter's agenda within 90 days of the referral; and

- Other matters as the PAB or the Commission deems appropriate.

Transparency is essential if a PAB is going to be a credible private sector regulatory body, develop the trust of both accountants and government bodies, and enhance the confidence of investors in the audit process and in the integrity of the information that fuels our securities markets. Public reports are one means of providing that transparency.

We request comment on our proposed public reporting provisions. Should we be more specific? Will the specified reports achieve an adequate level of transparency? If not, on what other types of reporting should we condition a PAB's Commission recognition? We also request comment on the appropriate timing and the scope of the reports.

#### Commission Oversight

As discussed above, under proposed section 13-04(i), Commission recognition is conditioned on a PAB's charter and bylaws providing that it will be subject to, and act in accordance with, Commission oversight. Our oversight authority under proposed section 13-04(i) is substantial. We expect to monitor closely the activities of any PAB and exercise particular aspects of our oversight authority whenever the public interest so requires. Among other things, under these proposed rules, the Commission may make changes to a PAB's rules, inspect and monitor a PAB's operations, review PAB disciplinary proceedings and modify or reverse any sanctions imposed, remove PAB board members under certain circumstances, redirect fees paid to a PAB that fails to comply with the conditions of recognition, and, ultimately, withdraw recognition. We believe that the system of private regulation proposed by the release, coupled with Commission oversight, is the best way to achieve our goals of improving audit quality and financial disclosure.

We envision a more thorough and extensive oversight of a PAB's processes than existed under the prior self-regulatory structure. We would intend to have full access to the process so that we would be able to determine to our satisfaction whether a PAB is operating in the interests of investors and working diligently to improve firms' quality

control systems, including sanctioning or removing from practice before the Commission incompetent or unethical individuals.

The proposed rule allows a PAB to set auditing, ethical and quality control standards, perform quality control and supplemental reviews, and impose disciplinary sanctions. As discussed elsewhere in this release, these powers are necessary in order for a PAB to improve audit quality and enhance public confidence in our markets. Because a PAB's influence on financial reporting will be significant, Commission oversight is necessary to ensure that a PAB exerts its influence exclusively in the public interest.

We request comment on the structure and scope of Commission oversight provided in the proposed rules. Would our goals better be served by a system of oversight that was less extensive? Why or why not? Should our rules set forth detailed criteria with respect to when the Commission would exercise its oversight? What should those criteria be?

Although we would not approve a PAB's rules before they take effect, as we do for the securities exchanges and others, one of the conditions of Commission recognition of a PAB would be, as set out in proposed rule 13-04(i)(1), that the PAB consent to and act in compliance with any Commission rule that abrogates, adds to, or deletes from the rules of a PAB. Using this provision, we could, by rule, amend a PAB's rules to remove inconsistencies, assure compliance with the securities laws or our regulations, and otherwise fulfill the purposes of Article 13. We would notify a PAB of our intention to take such action before we commenced a rulemaking proceeding. We also would follow our normal rulemaking process under the Administrative Procedure Act,<sup>118</sup> including publication of the proposed changes in the **Federal Register**, to solicit a wide range of comments on the proposed amendments. As discussed above, a PAB's charter and bylaws would provide that any changes we make to a PAB's rules would be immediately effective without further action by a PAB. We request comment on this provision. Should we review or approve of a PAB's rules before they take effect? Should the Commission amend a PAB's rules or should we only suggest or require that changes be made by the PAB itself? We request comment on our requirement that a PAB provide that any changes we make to a PAB's rules would be immediately effective. Does

this requirement raise any concerns in light of state law requirements in the areas of fiduciary duty and business judgment?

Under the self-regulatory structure, a 1982 memorandum of understanding ("MOU") among the Commission, the SECPS Peer Review Committee, the SECPS Executive Committee, and the POB significantly limited our oversight. For example, the MOU provided for the Commission staff to have access to POB staff workpapers, but only to certain workpapers of the peer reviewers on a random selection basis. The MOU also stated that the Commission staff was not permitted to retain or make copies of POB or reviewer workpapers.

Under proposed rule 13-04(i)(2), a totally different approach is proposed that would give the Commission the requisite involvement and oversight of a PAB's activities. Under the rule, our staff periodically may monitor and inspect the operations, records, and results of a PAB to ensure it is operating in the public interest and fulfilling the purposes of the Commission's rules. We intend that our staff would, in fact, regularly inspect the PAB's operations, records, and results, and would meaningfully monitor the PAB's operations. Among other things, we expect that monitoring to include our staff's attendance at meetings between a PAB and firms in connection with closing conferences at the completion of quality control reviews. The rule also requires a PAB to make and keep records that the Commission staff deems necessary for its inspections of the PAB's quality control reviews, supplemental reviews, and disciplinary activities.

We solicit comment on the approach to oversight in the proposed rules and on Commission involvement of a PAB's activities. How extensive should the involvement be of our staff in meetings between a PAB and a firm being reviewed? At what stage of the oversight process would our staff's involvement be most productive?

Because a PAB may limit or suspend an accountant's practice before the Commission, an adversely affected firm or individual should have the opportunity to seek Commission review of a PAB disciplinary decision. In addition, any member or adjunct member who is found delinquent in paying fees, producing documents or providing testimony should have an opportunity to seek Commission review of that determination. Under proposed rule 13-04(i)(3)(i), a PAB member accountant or adjunct member would have 30 days from the date the member accountant or adjunct member was

<sup>118</sup> See 5 U.S.C. 553 *et seq.*

notified by the PAB of the sanction or delinquency determination to file an application with the Commission for review. The Commission also could review a PAB sanction or delinquency determination on its own motion. A Commission review, however, would not stay the operation of the sanction unless the Commission so orders.

We seek comment on Commission review of a PAB disciplinary or delinquency action. Under the proposed rules, a PAB member or adjunct member would have 30 days to file an application for review. Is 30 days sufficient time to file an application? Should an application for review stay the operation of the sanction?

Under 13-04(i)(3)(ii), a Commission proceeding for review of a PAB's final disciplinary action against a member accountant would allow for notice and an opportunity for a hearing. The hearing may consist solely of consideration of the record before the PAB and opportunity for the presentation of supporting reasons to affirm, set aside, or modify the sanction. Under the proposed rule, the Commission would make a finding determining whether the member accountant engaged in the acts or omissions that the PAB found the accountant to have engaged in; whether those acts or omissions violated the provisions of the securities laws or rules thereunder, rules or membership requirements of the PAB, or professional standards that the PAB specified; and whether those provisions are, and were applied in a manner, consistent with proposed Article 13. If the Commission makes those findings, the Commission would by order so declare, and affirm or modify the sanction or, where appropriate, remand it to the PAB for further proceedings. If the Commission does not make those findings, it would set aside the sanction and, if appropriate, remand it to the PAB. We are not proposing that the Commission, during such a review, be able to increase the sanction imposed on the accountant. If the Commission deems a greater sanction to be necessary, it would initiate its own civil, administrative, or disciplinary proceedings.

Proposed rule 13-04(i)(3)(iii) sets forth similar procedures for Commission review of a PAB delinquency determination against a member or adjunct member. In proposed rule 13-04(i)(3)(iv), we have expressed specifically our authority to cancel, reduce, or require remission of a sanction or to cancel a delinquency determination, if we find that the sanction or delinquency determination imposes an unnecessary burden on

competition or is excessive or oppressive.

We request comment on the Commission proceeding to review a PAB's disciplinary actions or delinquency determinations. What should such a hearing entail? Should the rule allow for us to increase the sanction imposed on an accountant when appropriate? Under the proposed rules, we may cancel, reduce or require remission of a sanction or cancel a delinquency determination if it would impose an unnecessary burden on competition or is excessive or oppressive. Are these the appropriate instances when we should take such action? Are there other circumstances when we should act to ameliorate a sanction? What are they?

Proposed rule 13-04(i)(4) allows us, by order, to remove from office or censure any PAB board member if we find, after notice and opportunity for hearing that the member has (1) willfully violated any provision of the securities laws, rules or regulations thereunder, or the rules of the PAB; (2) willfully abused his or her authority; or (3) without reasonable justification or excuse failed to enforce a PAB member's compliance with any such provision or professional standards. In addition, under proposed rule 13-04(i)(5), if the Commission finds that a PAB is failing or has failed to comply with any of the conditions of recognition in proposed rule 13-04, we could withdraw recognition of the PAB and direct that PAB fees be deposited into escrow pending either correction of the PAB's failing or redirection of the funds to another PAB with which the formerly recognized PAB's members have enrolled.

Does our proposal set forth the appropriate circumstances for when we would remove from office or censure a PAB board member? We solicit comment on the redirection of funds to another PAB. Are there other circumstances that would warrant such action by the Commission? Are there alternative approaches for resolving or correcting a PAB's failure to meet the conditions of ongoing recognition?

We request comment on all aspects of Commission oversight of a PAB. Are there important aspects of Commission oversight that we have not identified? What are they? We request comment on our proposed rule that would allow us to withdraw recognition of a PAB.

#### F. Confidentiality and Immunity

Proposed rule 13-05(a) contains the Commission's finding that it is in the public interest for reports, memoranda, and other information prepared by, and

deliberations of, the PAB and its agents to receive appropriate confidential treatment under applicable law. We also find it in the public interest for a PAB to claim such protection, except to the extent that such information is requested by the Commission, any other Federal agency or department, any state licensing or criminal law authorities, and any foreign governmental or foreign financial regulatory authorities.

The Commission anticipates and intends that a PAB vigorously will claim confidentiality for its quality control review files, supplemental review files, and other files to the full extent permitted under law. Courts have recognized the strong public interest in allowing non-governmental entities entrusted with enforcing rules of conduct to minimize disclosure of investigative materials.<sup>119</sup> In *Ross v. Bolton*, the court noted the danger in "making NASD files fair game for any of the thousands of private securities fraud litigants across the country who wish to shortcut their own discovery efforts and instead to reap the benefits of the Association's ongoing, statutorily governed work."<sup>120</sup>

Those who possess information may be less forthcoming in responding to a PAB inquiry if they believe that the information they provide will be made public or made available to private litigants.<sup>121</sup> The PAB's efforts to improve audit quality accordingly would be hindered.<sup>122</sup> Additionally, we believe that in most instances a plaintiff's legitimate interest in obtaining discovery from a PAB will be slight at best. This particularly will be the case where the PAB is not a party to the litigation or where a PAB inquiry is not the subject of a plaintiff's claims.<sup>123</sup> Moreover, a plaintiff generally will be able to obtain the information it seeks from sources other than a PAB. Accordingly, a PAB's files should receive significant protection from compelled disclosure. The scope of

<sup>119</sup> See *Fiero Bros. v. Mishkin*, No. 95-08203 JLG, 1999 WL 1747410 (S.D.N.Y. Dec. 8, 1999); *Apex Oil Co. v. DiMauro*, 110 F.R.D. 490, 496 (S.D.N.Y. 1985); *Ross v. Bolton*, 106 F.R.D. 22, 23 (S.D.N.Y. 1985).

<sup>120</sup> *Ross*, 106 F.R.D. at 24.

<sup>121</sup> See *Apex Oil*, 110 F.R.D. at 496.

<sup>122</sup> Additionally, as with our own proceedings, substantial harm may occur to individuals, accounting firms, or registrants if materials are released either prematurely or after a determination has been made that allegations or suspicions of misconduct have not been substantiated sufficiently to warrant instituting a PAB disciplinary proceeding. Absent such confidentiality, the reputation of innocent professionals could be tarnished irreparably and the price of a registrant's securities could suffer based on unfounded suspicion or rumor.

<sup>123</sup> See *Apex Oil*, 110 F.R.D. at 497.

this protection, however, should not be so broad as to permit a PAB to deny Commission access to the PAB's materials, nor should it permit a PAB to deny access to the other governmental authorities described above.

We request comment on our proposal that the Commission find that information prepared by a PAB receive confidential treatment. Should such information be treated confidentially? Why or why not? Our proposal sets forth exceptions to confidentiality, such as information requested by a federal agency. Should our rules provide for other exceptions? We seek comment on the effect that discovery requests in private actions would have on a PAB inquiry. Would those who possess information be less willing to share information if the information could be subject to discovery in a private action? Is there some other way to address this concern besides a PAB maintaining confidentiality of the information?

In proposed Section 13-05(b), the Commission finds that public policy dictates that a PAB, its staff, contractors, and professional representatives should be immune from liability in a private civil suit for any action or failure to act in connection with the PAB's responsibilities under Article 13. We anticipate, and intend, that a PAB and its members and employees will claim and be entitled to immunity from private civil liability for any action or failure to act in connection with a PAB's responsibilities under the proposed rules.<sup>124</sup> Common law provides immunity for non-governmental actors who perform public functions such as the "development and promulgation of interpretations of statutory and regulatory requirements, the dissemination and implementation of these interpretations, and the provision of information to government agencies."<sup>125</sup> Accordingly, self-regulatory organizations ("SROs"), for example, have been held to enjoy immunity for actions taken within the scope of their duties as SROs, including interpretive, enforcement, adjudicatory, and referral activities.<sup>126</sup> Immunity from civil liability attaches because of, among other things, the likelihood of recriminatory lawsuits against SROs and

the safeguards against abuse provided by the Commission's oversight.<sup>127</sup>

Although we are proposing the framework for a private sector regulatory organization that is not self-regulatory in nature, a PAB and its employees should be immune for activities within the scope of their duties under these rules. Like an SRO, the PAB will further the purposes of the federal securities laws by setting standards, enforcing compliance, and providing the Commission with information. A PAB will perform critical public functions as it fulfills its mission to ensure reliable financial information and enhance public confidence in our markets. A PAB will, to the same extent as an SRO, be susceptible to lawsuits that could hamper its important public mission or discourage public-spirited persons from serving on a PAB. Finally, a PAB will be subject to Commission oversight to guard against abuses. Accordingly, a PAB and its employees should be immune from civil liability to the same extent as the SROs.<sup>128</sup>

We solicit comment on our proposed finding that a PAB be immune from private liability. Should we make such a finding? Would immunity be appropriate, as our proposed finding suggests, for staff, contractors, and professional representatives of a PAB? Are there reasons we should not find that such immunity is appropriate?

#### G. Exemptions

The Commission's broad exemptive authority<sup>129</sup> is reflected in proposed rule 13-06(a). Under this provision, on our own motion or upon an application by any interested party, we may exempt, conditionally or unconditionally, in whole or in part, any registrant, accountant, or class of registrants or accountants, from the operation of Article 13 and proposed rule 2-01(a)(2) of Regulation S-X.

In proposed rule 13-06(b), we would use our authority and exempt from the operation of Article 13 and proposed rule 2-01(a)(2) of Regulation S-X those accountants who do not audit or review financial statements filed with the

Commission on a recurring basis and whose audit reports are filed with us only in accordance with Rule 3-05 of Regulation S-X.<sup>130</sup> Rule 3-05 requires that the audited financial statements of certain businesses acquired, or to be acquired, by registrants be filed with the Commission. An audit of a private business that subsequently is acquired by a registrant, therefore, would not, by itself, require the accountant performing the audit to become a member of a PAB.

Under proposed rule 13-06(c), the Commission may relieve a PAB from any of its obligations under Article 13 to enforce rules or membership requirements of a PAB or professional standards with respect to any accountant, adjunct member, or class of accountants or adjunct members. We believe this proposal is appropriate to clarify our ability to address unintended consequences or unforeseen events that may occur and result in a need to suspend or alter the functions performed by a PAB.

We request comment on the proposed use of our exemptive authority. Should the Commission grant exemptions for accountants whose reports are filed only pursuant to Rule 3-09, regarding the financial statements of certain unconsolidated subsidiaries and "50 percent or less owned persons," or Rule 3-10, regarding the financial statements of certain guarantors and issuers of guaranteed securities?

#### H. Foreign Accountants

Under proposed rule 13-07(a), foreign accountants that audit or review financial statements filed with the Commission, and foreign issuers that engage foreign accountants for such services, would be exempt from the operation of Article 13 and proposed rule 2-01(a)(2) of Regulation S-X.<sup>131</sup> As noted above, under proposed section 13-03(c)(5), a PAB would study the quality control systems of foreign accountants and periodically report to us on whether the exemption provided to foreign accountants should be withdrawn. We would expect a PAB, at an appropriate time, to recommend that all or various classes of foreign accountants, conditionally or unconditionally, should be subject to proposed Article 13 and proposed rule 2-01(a)(2) of Regulation S-X.

In the meantime, we would require, under proposed section 13-04(e)(6), that domestic firms that are associated with foreign firms continue the current

<sup>124</sup> We do not intend anything in this rule to suggest that a PAB would or should be immune from civil law enforcement actions.

<sup>125</sup> See *D'Alessio v. New York Stock Exchange Inc.*, 125 F. Supp. 2d 656, 658 (S.D.N.Y. 2000), *aff'd*, 258 F.3d 93 (2d Cir. 2001).

<sup>126</sup> See *D'Alessio v. New York Stock Exchange Inc.*, 258 F.3d 93, 106 (2d Cir. 2001).

<sup>127</sup> See *Barbara v. New York Stock Exchange Inc.*, 99 F.3d 49, 59 (2d Cir. 1996); *Austin Municipal Securities, Inc. v. National Assoc. of Securities Dealers, Inc.*, 757 F.2d 676, 692 (5th Cir. 1985).

<sup>128</sup> The distinction between private regulation and self-regulation is important because under these rules the accounting profession will not be responsible for regulating itself. Rather, a private sector entity not controlled or dominated by accountants will assume this role. We do not believe, however, that distinction is relevant for the purposes of determining whether a PAB will be immune from civil liability.

<sup>129</sup> See, e.g., Section 36 of the Exchange Act, 15 U.S.C. 78mm.

<sup>130</sup> 17 CFR 210.3-05.

<sup>131</sup> This proposed exemption would not preclude the Commission from initiating Rule 102(e) proceedings or other appropriate proceedings when warranted.

practice of encouraging their international organizations and individual foreign associated firms to improve their quality control policies and procedures, in a manner consistent with the objectives of Article 13.<sup>132</sup> We also would expect that domestic firms would continue to urge their foreign associated firms to adopt policies and procedures that are at least as rigorous as those set forth in Appendix K to the current SECPS Membership Requirements.<sup>133</sup> These policies and procedures are intended to provide a mechanism for persons knowledgeable in United States accounting, auditing, and auditor independence requirements to assist foreign accountants in the performance of audits of financial statements included in filings with the Commission. Appendix K also addresses policies and procedures related to an annual inspection process that would include the review of a sample of audit engagements performed by foreign associated firms for clients that are Commission registrants.<sup>134</sup> We would require under proposed rule 13-04(e)(6) that domestic accountants would report to a PAB, as they currently report to the SECPS, the name and country of the foreign associated firms, if any, that have advised the domestic accountant that such policies and procedures have been put in place.<sup>135</sup>

In this regard, under proposed rule 13-07(b), during a review of a member firm's quality controls, a PAB or other reviewer would examine the procedures performed by the firm related to documents filed with the Commission that contain audit reports prepared by the firm's foreign associated firms.

<sup>132</sup> The Commission staff also will continue to seek comfort regarding a foreign accountant's knowledge of United States accounting, auditing, and auditor independence requirements as part of its review of filings or in anticipation of being requested to exercise its judgment in the public interest to accelerate the effectiveness of registration statements.

<sup>133</sup> Appendix K is available at <http://www.aicpa.org/members/div/secps/inmere.htm>.

<sup>134</sup> Persons knowledgeable in U.S. GAAP, GAAS and independence requirements and Commission regulations (the "inspection reviewers") would review the engagements. The inspection reviewers would determine whether anything came to their attention to cause them to believe that: (1) Either the financial statements did not comply with U.S. GAAP or the required reconciliation to U.S. GAAP did not include appropriate treatment of material reconciling items; (2) the audit engagement was not performed in accordance with U.S. GAAS; (3) the foreign associated firm did not comply with U.S. auditor independence requirements; and (4) the foreign associated firm did not comply with procedures for having Commission filings reviewed by a person knowledgeable in U.S. GAAP, U.S. GAAS, U.S. auditor independence requirements, and Commission regulations. See *Id.*

<sup>135</sup> SECPS, *Requirements of Members*, at n.

We request comments on our proposal regarding foreign accountants. Is the exemption for foreign accountants appropriate? There may be situations where, for example, a foreign company has the majority of its assets and operations in the United States and as a result it engages a U.S. firm to conduct the audit of the foreign company's financial statements. Should the exemption be broadened to include such a foreign issuer? Are there situations in which a U.S. firm's audit work for public companies is limited to companies that are foreign issuers? If so, should the exemption be broadened to include those issuers, but not broadened to include foreign issuers whose U.S. accounting firm also provides audit services to domestic issuers, and would therefore be required to be a PAB member anyway? Should we include an explicit provision to prevent domestic issuers from avoiding the PAB requirement by engaging a foreign accounting firm as their principal auditor?

#### *I. Disclosure by Directors, Executive Officers, Promoters, and Control Persons*

Under our proposed addition to item 401(f) of Regulation S-K,<sup>136</sup> disclosure would be required if, during the past five years, any director, person nominated to become a director, or executive officer was, in his or her capacity as a PAB member accountant, sanctioned by a PAB for violations of professional standards or the PAB's rules or membership requirements and that sanction has not been subsequently reversed, suspended, or vacated.

Item 401 currently requires disclosure of similar sanctions, such as court orders or judgments by federal or state authorities barring or limiting the right of the person to engage in activities related to, among other things, commodity trading, any type of business practice, or the purchase or sale of any securities.

A PAB sanction would be designed to protect investors from incompetent or unethical conduct or other failures to comply with professional standards. Such a sanction would be considered to be sufficiently serious that investors should be notified of the sanction for consideration in connection with investment or voting decisions.

We request comment on our proposal regarding disclosure. The disclosure requirement has been placed in Regulation S-K but not in Regulation S-B in order not to increase the compliance burden on small business issuers. We are considering, however,

placing the requirement in Regulation S-B as well. Should small business issuers make this disclosure? Assuming disclosure is required of PAB sanctions that have been imposed on executive officers, directors, or director nominees, should disclosure also be required of sanctions that have been imposed against such individuals in disciplinary actions under Rule 102(e) of the Commission's Rules of Practice? Should disclosure be required for sanctions that were imposed longer than five years ago?

#### *J. Transition Period*

We are considering the appropriate timing for the implementation of final rules, if any are adopted, and how best to allow for an orderly transition to the new rules. We are considering what, if any, delay would be necessary or appropriate in this case.

We could set a transition or compliance date that would allow additional time for a PAB to be established, recognized by the Commission, and in a position to begin accepting members. We anticipate that one or more entities seeking to be a PAB will submit appropriate information to the Commission soon after the final rules are published. We further anticipate that we would review that information promptly and, if practicable, issue an order recognizing a PAB by January 2003. Even though such a PAB might not be in a position for several months to begin conducting quality control reviews or disciplinary proceedings, it could begin accepting members soon after it conducts a rulemaking project related to the content and processing of accounting firms' applications.

One alternative, therefore, may be for a transition or compliance date to be based on the public issuance of the Commission's Order recognizing a PAB. For example, the compliance date could be 90 days after the public release of a Commission Order recognizing a PAB. Another alternative, which would encourage entities desiring to be a PAB to submit information to us promptly, might be to set a date certain or specific period of time after the effective date for full compliance with the rules.

We solicit comments on the appropriate timing for compliance with the proposed rules. Would a period of time beyond the effective date be necessary or appropriate for compliance with the rules? How should such a date be determined?

#### **IV. General Request for Comments**

We invite any interested person wishing to submit written comments on

<sup>136</sup> 17 CFR 229.401(f).

these proposed rules to do so. We specifically request comments from investors, accounting firms, and registrants and other audit clients. We solicit comment, both general and specific, on each component of the proposals.

#### V. Paperwork Reduction Act

Certain provisions of the proposed amendments to Regulation S-X and Regulation S-K contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA") (44 U.S.C. 3501 *et seq.*), and the Commission has submitted them to the Office of Management and Budget for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The titles for the collections of information are "Framework for a Public Accountability Board—PAB," "Framework for a Public Accountability Board—Accountants and Audit Clients," and "Regulation S-K" (OMB Control No. 3235-0071). Compliance with the collection of information requirements would be mandatory. There would be no mandatory retention period for the information, except as provided below. Responses to the disclosure requirements would not be kept confidential. The collections of information are necessary to provide assurance that audit, review, and attest services performed by accountants fulfill their statutory and regulatory purpose and enhance the confidence of investors in the audit and review processes and in reported financial information.

#### Information Provided by a PAB

We are proposing a collection of information entitled "Framework for a Public Accountability Board—PAB" for information that would be provided by a PAB to the Commission, the public and others. The respondents to this collection of information would be PABs and entities seeking Commission recognition as PABs. As discussed below, we estimate solely for the purposes of the PRA that only one PAB would respond to this collection of information. This collection of information is necessary to allow the Commission to oversee a PAB to ensure that it is operating in the public interest. In addition, the collection of information would provide the public with important information concerning a PAB's activities. Finally, the information is necessary to ensure that

the proposed rules operate effectively. This collection of information encompasses:

- An initial submission to the Commission;
- Notices concerning the loss of good standing;
- Requests to add items to agendas of standard-setters and related notices to the Commission;
- Publication of rules;
- Foreign accountants' quality controls report;
- Quality control review reports and files;
- Referrals to the Commission, markets, and exchanges;
- Notices of charges in disciplinary proceedings;
- Reports of sanctions;
- Public reports; and
- Record retention.

#### Initial Submission to the Commission.

Under proposed rule 13-03, an entity seeking Commission recognition as a PAB must make a submission to the Commission that would include its charter, bylaws, organizational structure, proposed budget, proposed board members and terms of board membership, and representations that it would perform certain functions and have rules, membership requirements, systems, and procedures to accomplish certain tasks. After evaluating this information and such other information as the Commission might request, the Commission would determine whether to recognize a PAB.

We estimate solely for the purposes of the PRA that only one entity would apply to be a PAB<sup>137</sup> and that it would prepare a charter, bylaws, and other governing documents for the purpose of incorporation under state law. While we would carefully scrutinize an entity's submission in order to determine its commitment and capacity to carry out the functions and to accomplish the purposes of a PAB, we do not believe that the submission would be onerous to prepare. As a result, for purposes of the PRA, we estimate it would take approximately 240 hours to prepare a submission to be filed with the Commission.

*Notices Concerning the Loss of Good Standing.* Under proposed rule 13-04(d)(11), a PAB would have in place rules to provide notices to the member or adjunct member, the Commission,

and the public of (1) any action that could result in a member or adjunct member's loss of good standing in the PAB, and (2) the loss of good standing by a PAB member or adjunct member. The notice requirements could be triggered by a failure to pay fees, produce documents or provide testimony, or by noncompliance with a PAB sanction.<sup>138</sup> We expect that such notices would be rare. Accordingly, for the purposes of the PRA, we estimate that a PAB would provide 15 such notices each year. The paperwork burden involved in preparing the notice would be minimal because the notice would consist only of a short, factual statement. Accordingly, we estimate that each notice would require one hour to prepare, and that 15 burden hours per year would be spent on preparing these notices.

*Requests to Add Items to Agendas of Standard-Setters and Related Notices to the Commission.* Under proposed rule 13-04(d)(12), a PAB would either set audit, quality control and ethics standards or designate private sector bodies' standards as authoritative. If it chooses the latter, it would notify the Commission any time it requests that a private sector standard-setter add an item to its agenda. Proposed rule 13-04(d)(13) would require a similar notice to the Commission any time a PAB requests that a private sector body that sets accounting or independence standards add an item to its agenda.

For purposes of the PRA, we estimate that, after it completes its quality control review cycle, a PAB would make approximately five requests to standard-setting bodies to add several items to each body's agenda reflecting concerns that arose during the quality control review process.<sup>139</sup> Each request would necessitate a letter to the appropriate standard-setting body, and would require a PAB to consider carefully any requests it would make. We therefore estimate, for purposes of the PRA, that each such request letter would require approximately 40 burden hours. The required notice to the Commission could simply include a copy of the request and an appropriate cover letter. As a result, the notice to the Commission would result in little additional burden. We estimate for

<sup>138</sup> As discussed below, proposed rule 13-04(d)(11) also requires notice when the PAB takes action that could result, or results, in a suspension or bar from the PAB. The burden that would result from these notices is discussed in the section entitled "Notices of Charges in Disciplinary Proceedings," below.

<sup>139</sup> We estimate that a PAB might make one request regarding each of the five types of standards enumerated in the proposed rules.

<sup>137</sup> We use this assumption, which we make solely for the purposes of the PRA, throughout this discussion of the information collection requirements that would be imposed by the proposed rules. Thus, wherever an estimate of the number of PABs is necessary to calculate an estimated paperwork burden, we assume that there will be only one PAB.

purposes of the PRA that such a notice would require approximately one burden hour. Accordingly, we estimate that this aspect of the proposed rules would impose 205 burden hours per year.

**Publication of Rules.** Under proposed rule 13-04(d)(14), a PAB would provide an open and deliberative rulemaking process that would include publication of draft rules for notice and comment. We expect that a PAB would publish a large number of rules during its first year after recognition. In later years, we expect that a PAB would publish fewer, if any, new rules per year. Thus, we estimate, for the purposes of the PRA, that, on average, a PAB will publish approximately ten new rules per year. We expect that a PAB would expend significant time and effort in developing appropriate rules and requirements for its members. We also expect that a PAB would make its rules available to its members. Therefore, we estimate for purposes of the PRA that a PAB would spend, on average, approximately 200 burden hours for each rule it publishes. Accordingly, we estimate that this aspect of the proposed rules would impose approximately 2,000 burden hours per year.

**Foreign Accountants' Quality Controls Report.** Under proposed rule 13-03(c)(5), a PAB would study and periodically report to the Commission on matters related to the quality controls of foreign accountants. Foreign accountants are not covered by the proposed rules. A PAB would, however, periodically review whether foreign accountants should be subject to the rules, and report to the Commission on that issue. This proposed rule might require foreign travel, an analysis of various foreign legal and regulatory requirements, an analysis of foreign professional standards, and other items. We therefore estimate for the purposes of the PRA that this aspect of the collection of information may require 1,000 burden hours.

**Quality Control Review Reports and Files.** Under the proposed rules, a PAB would issue a report at the end of each PAB-directed quality control review. A PAB-directed review would be required each year for accounting firms with more than 70 SEC clients. We estimate that there are currently approximately ten firms with more than 70 SEC clients;<sup>140</sup> a PAB would therefore issue approximately ten such reports each year. We estimate that under the current SECPS system, a report requires

approximately 40 burden hours to prepare. We expect that preparing a PAB quality control review report should take approximately the same amount of time. We therefore estimate, for purposes of the PRA, that a PAB would require approximately 400 burden hours per year to complete reports of quality control reviews.

Under the proposed rules, a PAB also would maintain public files of all quality control review reports and any responses to the reports by the reviewed accounting firms. According to our records, there are approximately 850 domestic accounting firms that currently perform audits for SEC registrants. Accordingly, we estimate that approximately 850 accounting firms would be members of a recognized PAB under the proposed rules. Ten of these firms would undergo a PAB-directed quality control review each year. The remaining 840 firms would be reviewed at least every three years. We therefore estimate that each year, a PAB would create or add to 290 public files of quality control review reports.<sup>141</sup> Making the reports publicly available by maintaining them in a public file would not impose a significant burden. As a result, we estimate for purposes of the PRA that publicly maintaining one report would require one burden hour. Thus, 290 burden hours would be expended per year on this aspect of the proposed rule.

**Referrals to the Commission, Markets and Exchanges.** Under proposed rule 13-04(g)(2), a PAB would report information indicating a violation of the securities laws to the Commission. Under proposed rule 13-04(g)(8), a PAB would similarly refer matters to the Commission anytime it is unable to conduct or complete a supplemental review or a disciplinary proceeding because of the refusal of any person to cooperate. If an uncooperative party is a registrant, the PAB would also report the registrant's lack of cooperation to the relevant market or exchange. A PAB would also refer any other matter it deems appropriate to the Commission. Although we cannot estimate with precision how frequently a PAB would make such a referral, for purposes of the PRA we estimate that a PAB would make 20 such referrals per year. These reports would likely be fact specific, and not result in significant burdens.

<sup>141</sup> We derived this number by assuming that each year, one-third of the accounting firms not subject to an annual PAB-directed review will be reviewed under a PAB-approved program. Thus, 280 of these firms would be reviewed per year. In addition, each year a PAB would review the ten firms with more than 70 SEC clients. As a result, the PAB would create or add to 290 public files per year.

The reports might be oral or written, and might be accompanied by such information that indicates a violation or non-cooperation. We estimate that these reports will require approximately two burden hours each, and therefore that 40 burden hours per year would be required to comply with this requirement.

**Notices of Charges in Disciplinary Proceedings.** Under proposed rule 13-04(g)(3), a PAB would notify a member of specific charges in any disciplinary proceeding. We anticipate that this notice would be similar to a complaint or an order instituting administrative proceedings. Based on our experience with disciplinary proceedings against accountants, we estimate that a PAB might initiate approximately 75 disciplinary proceedings per year.<sup>142</sup> This notice would require careful formulation and, possibly, legal review. Additionally, under proposed rule 13-04(d)(11), any disciplinary proceeding that could result in suspension or bar of a member accountant would trigger a requirement that a PAB provide notice, in addition to the member accountant, to the Commission, and to the public. Solely for the purposes of the PRA, we estimate that a PAB also would provide notice under 13-04(d)(11) each time it institutes disciplinary proceedings against an accountant. We estimate for the purposes of the PRA that approximately 30 burden hours would be required to complete both notices, and that a PAB would therefore expend 2,250 hours per year on this aspect of the proposed rules.

**Reports of Sanctions.** Under proposed rule 13-04(g)(7), anytime a PAB imposes a disciplinary sanction on an accountant, the PAB would report the sanction to the Commission, the public, and the appropriate state or foreign authorities. These reports would include the name of the accountant being sanctioned, a description of the acts or omissions upon which the sanction is based, the nature of the sanction, and such other information as a PAB deems appropriate. Based on our experience with disciplinary proceedings against accountants, we anticipate that a PAB may make approximately 50 such reports each year. Assuming for purposes of the PRA

<sup>142</sup> The Commission initiates approximately 100 cases per year related to deficient financial reporting. See, e.g., SEC, *Annual Report 2001*, at 134. We estimate that approximately one-half of these cases involve disciplinary actions against accountants. Because of its ability to detect issues during its reviews, we expect that a PAB would initiate at least as many actions as, and possibly more than, the Commission. Accordingly, we estimate that a PAB may initiate 75 disciplinary proceedings per year.

<sup>140</sup> We make this assumption based on a list of SECPS member firms compiled by the SECPS. See *supra* note 111.

that preparation and internal legal review of one report would require approximately 50 burden hours, there would be an annual burden of approximately 2,500 hours imposed by this requirement.

**Public Reports.** Under proposed rule 13–04(h), a PAB would report to the public and the commission at least annually, and where practicable on a current basis, detailed descriptions of its activities, annual audited financial statements, explanations of its fees and charges, a summary of issues discussed with private sector standard-setting bodies, a list of matters referred to each standard-setter that were not placed on the standard-setter's agenda within 90 days, and such other information as a PAB considers appropriate or that the Commission requires by order. All of the information required would be readily available to a PAB. Nevertheless, some time would be required to compile the information and put it into usable form. We estimate for purposes of the PRA that 200 burden hours per year would be associated with the preparation of these reports. Burdens associated with preparation of the reports might be minimized if a PAB creates a website and updates information on that website on an ongoing basis.

**Record Retention.** Under proposed rule 13–04(i)(2), a PAB would be required to make and keep records that the Commission staff deems necessary for its inspection of the PAB's quality control review activities, supplemental reviews, and disciplinary proceedings. A PAB would adopt a record retention policy that would be approved by the Commission. The policy would provide for the retention of records until the Commission has either inspected them or informed the PAB that they no longer need to be retained. In addition, under proposed rule 13–04(g)(3), a PAB would keep a record of its disciplinary proceedings. We estimate for purposes of the PRA that 1,000 burden hours would be associated with these recordkeeping requirements.

We therefore estimate for purposes of the PRA that a total of approximately 10,140 burden hours would be imposed on a PAB by this collection of information. We estimate that approximately 25% of these hours would be expended by a PAB's outside lawyers, while the rest would be incurred in-house. Assuming a cost of \$300 per hour for outside legal expenses, the cost associated with the burden hours incurred by a PAB's outside counsel would be \$760,500.

#### *Information Provided by Accountants and Audit Clients*

The proposed rules would require accountants that are members of a PAB to provide certain information to the Commission, a PAB, the public, and others. A primary focus of the proposed rules is on the thoroughness of the quality control reviews and disciplinary proceedings resulting from these reviews. For the most part, the information to be provided by accountants currently is reported to the SECPS, or is otherwise required under professional standards. We assume that, if the proposed rules are adopted, the SECPS would no longer impose any requirements that would be duplicative of PAB requirements. In many instances, therefore, the proposed rules would simply require that information be directed to a PAB rather than the SECPS. Accordingly, most of what the proposed rules would require from accountants is usual and customary and would not impose a new burden.<sup>143</sup>

We estimate, however, that approximately 80 accounting firms that are not currently members of the SECPS would likely become members of a PAB under the proposed rules.<sup>144</sup> These firms are, we believe, smaller firms with one or two SEC clients that chose not to join the SECPS. Under the proposed rules, however, these firms would likely join a PAB in order to maintain those SEC clients. These firms would incur new paperwork burdens under the proposed rules, and we have estimated these burdens below, along with new burdens that would be imposed on all PAB-member accounting firms, regardless of membership in the SECPS.

This information collection is necessary to enhance investor confidence that auditors of public companies are acting in the public interest and in furtherance of the purposes of the federal securities laws. The information would be used by a PAB, accounting firms, registrants, and the public to monitor accountants' compliance with the federal securities laws, PAB rules, and professional requirements. The respondents to this collection of information would be accountants and, extremely rarely

(resulting in no more than approximately 15 burden hours, as discussed below), audit clients. As discussed below, we estimate that approximately 850 accounting firms would respond per year to the proposed collection of information requirements. In addition, up to approximately 53 individual accountants and 3 audit clients per year might respond to the collection of information requirements, depending on circumstances.<sup>145</sup> The title for this collection of information is "Framework for a Public Accountability Board—Accountants and Audit Clients." The collection of information would encompass:

- Enrollment procedures;
- Auditor independence reports;
- Reports concerning the termination of an auditor-client relationship;
- Notices upon beginning employment discussions;
- Reports concerning foreign associated firms;
- Reports concerning litigation and government investigations or proceedings;
- Applications for Commission review;
- Quality control review reports;
- Record retention; and
- Notices concerning the hiring or retention of sanctioned individuals.

**Enrollment Procedures.** Under proposed rule 13–04(d)(1), a PAB would provide for membership enrollment procedures that would minimize the administrative burden on individual accountants by maximizing the extent to which the enrollment requirements could be satisfied by an accounting firm on behalf of its individual accountants. A PAB would develop its own procedures under this proposed rule. We expect, however, that most likely a PAB would require each member accounting firm to provide at least a list of the individual accountants working for the firm. We believe that accounting firms will have this information, and the other information a PAB might require, readily available. For the purpose of the PRA, we estimate that each member-accounting firm might expend five burden hours per year on enrollment in a PAB and any updating requirements.

<sup>143</sup> See 5 CFR 1320.3(b)(2) ("The time, effort, and financial resources necessary to comply with a collection of information that would be incurred by persons in the normal course of their activities (e.g., in compiling and maintaining business records) will be excluded from the 'burden' if the agency demonstrates that the reporting, recordkeeping, or disclosure activities needed to comply are usual and customary.').

<sup>144</sup> We estimate that the audit reports of approximately 850 domestic accounting firms are filed with the Commission, and that approximately 770 of these firms are SECPS members.

<sup>145</sup> Individual accountants and audit clients could, in rare cases, be subject to this collection of information. First, as discussed below, individual accountants could provide a notice upon beginning employment discussions with an audit client. Because such notices are already required, however, individual accountants would incur no new burden with respect to this usual and customary activity. Second, as discussed below, we estimate that as many as 53 individual accountants and 3 audit clients per year might file applications for Commission review of PAB disciplinary sanctions or delinquency determinations.



Above, we estimated that approximately 850 accounting firms would be members of a PAB under the proposed rules. Accordingly, we estimate that accounting firms might expend 4,250 hours on enrollment procedures.

**Auditor Independence Reports.** Under proposed rule 13-04(e)(4), each accounting firm that is a member of a PAB would disclose at least annually to the audit committee of each audit client that is a Commission registrant all relationships between the accountant and its related entities that may bear on auditor independence, and confirm that it is independent of the registrant. Reports such as these have been required since 1999 by Independence Standards Board Standard No. 1.<sup>146</sup> Accordingly, all accounting firms that would be members of a PAB already make such reports. Thus, these reports are usual and customary and no new burden would be imposed.

**Reports Concerning the Termination of an Auditor-Client Relationship.** Under proposed rule 13-04(e)(5), when an accountant's relationship with a Commission registrant ends, a PAB member accountant would report this fact to the registrant and the Commission. The proposed rule simply codifies a long-standing SECPS requirement.<sup>147</sup> Accordingly, all accountants that are members of the SECPS already are making such reports. Therefore, these reports are a usual and customary activity for SECPS members, and no additional burden would be imposed on them.

As discussed above, we estimate that approximately 80 accountants that are not currently members of the SECPS would be members of a PAB under the proposed rules. These firms would most likely be smaller firms, with longstanding personal relationships with their one or two SEC clients. We believe that each year only a few of these firms would be required to provide notice of the termination of a relationship with a Commission registrant. We estimate, therefore, for the purposes of the PRA that approximately 6 of the 80 accountants that are not members of the SECPS would be required to make one of these reports each year. The report should require no more than one or two sentences and should not take more than one-half hour. We therefore estimate for purposes of the PRA that

this requirement would impose 3 burden hours on accountants.

**Notices Upon Beginning Employment Discussions.** Under proposed rule 13-04(e)(9), a PAB would ensure that its member accounting firms have policies requiring prompt notification to the firm when an individual accountant who is a partner or employee of the firm begins employment discussions with an audit client. Under Independence Standards Board Standard No. 3,<sup>148</sup> all accounting firms that would be members of a PAB are already required to make such reports. Accordingly, this is a usual and customary activity and no new burden would be imposed.

**Reports Concerning Foreign Associated Firms.** Under proposed rule 13-04(e)(6), PAB member accountants would report at least annually the name and country of any foreign associated firms that have notified the PAB member in writing that they have adopted policies and procedures that are consistent with proposed Article 13. Currently, accounting firms make such reports to the SECPS; these reports are therefore a usual and customary practice.<sup>149</sup> Having such reports directed to a PAB instead of to the SECPS would impose no additional burden.<sup>150</sup>

**Reports Concerning Litigation and Government Investigations and Proceedings.** Under proposed rule 13-04(e)(7), a PAB would adopt a rule requiring its member accounting firms to have policies or procedures in place to report to the PAB, with a copy to the Commission, litigation or any proceeding or investigation by a government agency alleging deficiencies in an audit or review or violations of the securities laws. Currently, these reports are made to the SECPS QCIC.<sup>151</sup> Accordingly, the proposed rule should not increase the burden of this usual and customary activity for accounting firms that are members of the SECPS.

This proposed rule, however, would impose a new paperwork burden for any of the approximately 80 accounting firms that are not members of the SECPS but would be members of a PAB. We expect that litigation or government investigations or proceedings involving these firms would be relatively rare. Accordingly, we estimate that two of these 80 firms would report litigation or

government investigations or proceedings once per year. We expect that a firm could satisfy the reporting requirement by sending the PAB and the Commission a copy of the complaint (or other relevant document) with a short cover letter. We therefore estimate for purposes of the PRA that one burden hour would be required to satisfy the proposed requirement, and that accounting firms would therefore incur two burden hours per year under this aspect of the proposed rules.

**Applications for Commission Review.** Under proposed rule 13-04(i)(3), any final PAB disciplinary action or determination of a loss of good standing as a result of a failure to pay fees, produce documents, or provide testimony is subject to Commission review upon application by any person aggrieved by the action. An application for review would not need to be lengthy or burdensome. We therefore estimate for purposes of the PRA that such an application would require approximately 5 burden hours.

We estimated above that a PAB might sanction approximately 50 accountants per year. Assuming, for purposes of the PRA, that each sanctioned accountant requests Commission review, accountants would file 50 applications each year. These accountants could include individual accountants as well as accounting firms. We estimated above that a PAB might issue 15 notices per year that a member or adjunct member might lose, or has lost, good standing as a result of either: (1) Failing to pay fees, produce documents, or provide testimony, or (2) not complying with a PAB sanction other than a suspension or a bar. We expect that few of these notices would result from an actual loss of good standing as a result of a failure to pay fees, produce documents, or provide testimony. Accordingly, we estimate for purposes of the PRA that 3 accounting firms, individual accountants, or adjunct members would make one request each for Commission review of such a good standing determination per year. Thus, for purposes of the PRA, we estimate that this aspect of the proposed rules would impose 265 burden hours. Up to fifteen of these hours could be incurred by audit clients, depending on the circumstances.

**Quality Control Review Reports.** As discussed above, the proposed rules would require all members of a PAB to undergo quality control reviews. A PAB would direct the reviews of all members

<sup>146</sup> Independence Standards Board, *Independence Discussions with Audit Committees*, Independence Standard No. 1 (Jan. 1999).

<sup>147</sup> SECPS, *Requirements of Members*, at m. These requirements are available at [www.aicpa.org/members/div/secps/require.htm](http://www.aicpa.org/members/div/secps/require.htm).

<sup>148</sup> Independence Standards Board, *Employment with Audit Clients*, Independence Standard No. 3, (July 2000).

<sup>149</sup> SECPS, *Requirements of Members*, at n.

<sup>150</sup> We expect that none of the approximately 80 smaller firms that are not members of the SECPS but would be members of a PAB would have foreign associated firms.

<sup>151</sup> SECPS, *Requirements of Members*, at k.

with more than 70 SEC clients.<sup>152</sup> Reviews of PAB members with 70 or fewer SEC clients could be conducted under a review program approved and monitored by the PAB.

Under the SECPS system, accountants already prepare reports at the conclusion of reviews. Preparation of such reports, therefore, is a usual and customary activity for accountants. We expect that the SECPS will no longer require reviews if our proposed rules are adopted. While we expect that our proposed quality control review system would provide increased confidence in the reliability of audited financial statements, we do not expect that the preparation of the reports would require more burden hours than is currently required. While we estimate that there are approximately 1,250 SECPS members (some of whom do not in fact audit financial statements of public companies), we have estimated that approximately 850 accounting firms would be members of a PAB. Accordingly, no new burden would be imposed by this aspect of the proposed rules.

**Record Retention.** Under proposed rule 13-04(d)(5), a PAB would adopt rules or membership requirements that direct member accounting firms to make and keep for specified periods of time records that are required by professional standards or that otherwise document procedures performed and the resolution of material issues during audit and review engagements. Additionally, proposed rule 13-04(f)(2) would require a PAB to direct its members to make and keep, for such periods as the PAB determines necessary, records that are necessary for the conduct of quality control reviews. The creation and retention of such records already is required by GAAS and, therefore, is a usual and customary activity within the accounting profession.<sup>153</sup> Accordingly, accounting firms would not incur a new paperwork burden associated with this proposed rule. We do not know whether a PAB might impose rules requiring longer retention periods than are currently in place at accounting firms. Any such requirement, and resulting incremental burden, would be a function of PAB rules.

**Notices Concerning the Hiring or Retention of Sanctioned Individuals.** Finally, under proposed rule 13-

04(g)(9), a member firm would notify a PAB if the firm employs or becomes associated with an individual during any period in which that person is subject to a sanction, order, or ruling issued by a PAB. This notice would alert the PAB to consider, during quality control reviews, whether the firm and individual are in compliance with the PAB sanction. We anticipate that the notice would be relatively short and identify the individual, firm, sanction, and public report announcing the sanction. Such a report should take less than an hour to prepare. We estimate that no more than 10 such reports would be made in any year. Accordingly, compliance with this provision would require approximately 10 burden hours.

Thus, member-accounting firms would incur a total of approximately 4,530 burden hours.<sup>154</sup> We estimate that approximately 25% of these 4,530 hours would be expended by outside lawyers, while the rest would be incurred in-house. Assuming a cost of \$300 per hour for outside legal expenses, the cost associated with the burden hours incurred by outside counsel would be \$339,750.

#### *Information Disclosed by Registrants*

We have proposed an amendment to item 401 of Regulation S-K<sup>155</sup> that would require disclosure if, within the last five years, any director, person nominated to be a director, or executive officer was sanctioned by a PAB for violations of professional standards or the PAB's rules or membership requirements and that sanction has not been subsequently reversed, suspended, or vacated. This information is necessary to alert investors of violations of PAB membership requirements or professional standards by directors, persons nominated to be directors, and executive officers. Investors would use this information to help them make informed investment decisions. The potential respondents are registrants. Below, we estimate that approximately 10 registrants per year would make one disclose each under the proposed amendment.

The title for the collection of this information is "Regulation S-K" (OMB Control No. 3235-0071). This regulation was adopted pursuant to the Securities Act and the Exchange Act and sets forth

disclosure requirements for annual and quarterly reports, registration statements, and proxy and information statements filed by registrants to ensure that investors are informed. The proposed disclosure requirement would provide investors with important information regarding executive officers, directors, and director nominees. The hours and costs associated with preparing, filing, and sending these disclosures constitute reporting and cost burdens imposed by each collection of information. Regulation S-K, however, historically has carried only one response and one burden hour because the burdens associated with the items within Regulation S-K are reflected in the estimated burdens assigned to each form, report, or registration statement.

For disclosure to occur under the proposed amendment, an individual would have to be sanctioned by a PAB, not have that sanction reversed, suspended, or vacated, and within five years from the date of the sanction become an executive officer, director, or director nominee of a public company. We anticipate that these circumstances will occur infrequently. We estimated above that approximately 50 accountants might be sanctioned by a PAB per year. It is difficult to estimate, however, how many of these sanctioned individuals might be engaged to serve as an executive officer or director of a public company. Solely for the purpose of the PRA, we estimate that this disclosure would occur approximately ten times per year. It most likely would appear in a Form S-1 (OMB Control No. 3235-0065), Schedule 14A (OMB Control No. 3235-0059), or Form 10-K (OMB Control No. 3235-0063).<sup>156</sup> Such disclosure may be no more than a few lines that include a citation to the sanction and clarifying information, if any. Because it may be a relatively brief disclosure, printing and dissemination costs should be inconsequential. We estimate that no more than three burden hours would be required to prepare and review such disclosure, for a total burden of 30 hours. This burden would be divided evenly among Form S-1, Schedule 14A, and Form 10-K. Our proposal would therefore increase the burden hour inventory for Form S-1 from 196,846 to 196,856, the burden hour inventory for Schedule 14A from 98,868 to 98,878, and the burden hour inventory for Form 10-K from 12,309,462 to 12,309,472.

<sup>152</sup> The burden imposed by the reports at the conclusion of these reviews is included in the information collection entitled "Framework for a Public Accountability Board—PAB" discussed above.

<sup>153</sup> See generally, SAS No. 96, AU § 339 (as revised 2002).

<sup>154</sup> As described in the section entitled "Applications for Commission Review," above, we estimate that up to 265 of these hours might instead be incurred by up to 53 individual accountants, and up to 15 of these hours might instead be incurred by up to three audit clients, depending on the circumstances.

<sup>155</sup> 17 CFR 229.401.

<sup>156</sup> Item 401, Regulation S-K disclosures are required by, among other provisions, item 11(k) of Form S-1, item 10 of Form 10-K, and item 7 of Schedule 14A; 17 CFR 239.11, 240.14a-101, and 249.310 respectively.

### *Solicitation of Comments*

Pursuant to 44 U.S.C. 3506(c), we solicit comments to: (1) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) evaluate the accuracy of our estimates of the burdens of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burdens of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609, with reference to File No. S7-24-02. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-24-02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

### **VI. Cost-Benefit Analysis**

We are sensitive to the costs and benefits imposed by our rules, and we have identified certain costs and benefits of these proposals. We request comment on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits. We encourage commenters to identify and supply relevant data concerning the costs or benefits of the proposed amendments.

#### *A. Background*

In the wake of recent corporate failures that caused significant losses to investors and pensioners, Congress, the Commission, and others have been examining longstanding deficiencies in

the accounting profession's self-regulatory programs. During this examination, the POB, which had overseen the profession's programs since 1977, voted to disband.

Many of the criticisms of the accounting profession that existed when the current self-regulatory process was created in 1977 continue to exist today. Congressional hearings held in the first half of 2002, reminiscent of those held approximately 25 years before, considered why major corporations have failed without adequate warning in the companies' financial reports. Witnesses during those hearings expressed a lack of confidence in the self-regulatory system and the need for change.<sup>157</sup>

Our proposals would create the framework for a new private sector regulatory structure for accountants that audit or review financial statements, or prepare attestation reports, that are filed with the Commission. Under the proposed rules, these accountants would be members of a Public Accountability Board, or PAB. A Commission registrant engaging an accountant to perform such services would be an adjunct member of the same PAB to which the accountant belongs.

As discussed in detail above, our objective is to lay the foundation for a new, stronger system of private sector regulation that would enhance investor confidence in the audit process and in the reliability of the financial information used to make investment and voting decisions.

A PAB would oversee the quality of financial statements relied on by investors by, among other things, directing periodic reviews of accounting firms' quality controls over their accounting and auditing practices and, when appropriate, disciplining accountants for deficiencies noted during those quality control reviews or otherwise coming to a PAB's attention. We focused on the need for a PAB to be able to remedy any deficiencies in standards that it may detect during quality control or disciplinary proceedings. The rules provide, therefore, that a PAB also would set, or rely on designated private sector standard-setting bodies to set, audit, quality control, or ethics standards, and

would facilitate communications among these bodies and others.

A PAB would be required to meet the conditions specified in the proposed rules to be recognized by the Commission. These conditions include Commission oversight and a board dominated by persons who are not members of the accounting profession. To ensure that result, our rules would set a maximum number of accountant-board members. A PAB, with a significant majority of public members, a diligent quality control review process, effective disciplinary proceedings, the ability to set standards or influence standard setters, and close oversight by the Commission, should be in a position to make meaningful improvements in the quality of audits and enhance the confidence of investors in both the audit process and in the reliability of financial information.

The proposal addresses the need for all accountants providing audit, review or attest services to Commission registrants to have a strong, effective organization that could operate in the public interest without fear of losing its funding. We therefore included in our framework provisions regarding membership in such an organization, continuous and involuntary funding, and an effective disciplinary mechanism. The proposal also would allow a PAB to collect fees from its members and adjunct members to fund not only its own administration and operations, but also the administration and operations of an accounting standard-setting body recognized by the Commission, which currently is the FASB. We have included funding for the FASB in our proposal because that body currently collects funds primarily through donations from, and by selling its publications to, accounting firms and corporations. There is a perception that such funding may be increased or decreased based on the reaction of accounting firms or companies to proposed accounting standards.<sup>158</sup> To remove this perception, a PAB would establish a mandatory and continuous source of funding for the FASB. A PAB would collect sufficient fees from its

<sup>157</sup> See, e.g., *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Mar. 19, 2002). For discussion of the profession in 1977, see, e.g., Staff of Subcomm. on Reports, Accounting, and Management of the Senate Comm. on Government Operations, 95th Cong., *Report on the Accounting Establishment: A Staff Study*, 7 (Subcomm. Print Mar. 31, 1977).

<sup>158</sup> See, e.g., Stephen Barr, *FASB Under Siege*, CFO Magazine, Sept. 1994, at 34, 46, which states that the FASB reported reduced contributions during the debate over the accounting for employee stock options, and Dean Foust, *It's Time to Free the FASB Seven*, Bus. Wk., May 3, 1993, at 144, which states: "It's time to free the FASB Seven [board members] from this outside influence—beginning with their financial support. . . . Critics contend that some executives have threatened to withhold support if FASB doesn't vote their way. A good solution is to require that corporations filing documents with the SEC pay a small sum each time to create a permanent endowment for FASB."

members and adjunct members to fund the FASB and then transfer those funds to it.

Our proposal would keep the requirements under the current system that we believe increase the quality of audits. Our proposal would place these requirements, however, in a stronger system that is more independent from the profession, more transparent, more closely overseen by the Commission, more willing and able to discipline its members, and more efficient in coordinating the efforts of the various participants in the regulatory process. In addition, we are adding features to the current system, such as public disciplinary proceedings by a PAB, increased frequency of reviews of the largest firm's quality control systems, and requiring maintenance of a central office function with expertise in accounting and financial reporting matters.

Congressional proposals, suggestions made during the SEC Roundtables, the U.K. system of regulation of the accounting profession, and recommendations submitted by others, all of which are discussed above, have provided numerous alternatives for the regulation of the accounting profession. Based on that input, we considered alternative frameworks that would include, among other things:

- Different mixes of accountant and "public" representatives on a PAB's governing board;
- Membership for accounting firms only, and not for individual accountants or registrants;
- Different funding sources and more specific methods of collecting fees assessed by a PAB;
- Funding that did not include the FASB;
- No standard-setting responsibilities;
- More disciplinary authority, including the authority to compel the production of documents and testimony from persons who are neither members nor adjunct members of a PAB; and
- Foreign accountants as members.
- An increased level of Commission oversight over the current self-regulatory system.

Of the alternatives considered, we believe that our proposal would best protect investors.

#### *B. Potential Benefits of the Proposed Rules*

Potential benefits to the proposed rule amendments include increased investor confidence in the audit process and in the reliability of reported financial information, and enhanced corporate governance resulting from more disclosure about directors and officers.

Accountants and registrants also may benefit from a more streamlined and efficient regulatory process.

The benefits of a stronger, more transparent, and more efficient regulatory system for the accounting profession should translate into increased investor confidence in the audit process and in the financial information provided to our securities markets. If the rule amendments lead to increased investor confidence in financial reporting, they also may encourage investment and facilitate capital formation. Issuers, therefore, may be able to lower their cost of capital, or raise capital where they might have been unable to do so. Additionally, the benefits of enhanced disclosure by directors, director nominees, and officers should translate into enhanced corporate governance in registrants. These benefits flow from the following six points, as well as other features of our proposal:

1. *Independence from the accounting profession and assured funding.* A PAB established under our framework would be outside the realm of the AICPA. Representatives of investors and issuers, not accountants, would dominate a PAB's governing board, would actively participate in directing quality control reviews of large accounting firms, and would evaluate the quality control reviews of smaller firms. Funding, instead of being dependent on the AICPA, would be mandatory and flow from both accountants and registrants. Continuous and mandatory funding also would be provided for the FASB, which sets accounting standards.

2. *Periodic reviews.* The current ability of an accounting firm to avoid periodic reviews of its quality control system, simply by deciding not to join a regulatory organization, would be removed. Reviews of quality control systems would occur more often for some firms and for the first time for some firms that were not previously members of the SECPS. Because registrants would be adjunct members, the payment of fees by registrants and the cooperation by registrants in a PAB's quality control reviews and disciplinary proceedings, would be assured.

3. *Enhanced quality of audit, review, and attest services.* High quality audit, review, and attest services form a cornerstone of the Commission's full disclosure system. A PAB, after conducting an appropriate disciplinary process, could suspend individuals and firms from conducting audits and reviews of financial statements and from preparing attestation reports filed with us, or impose other appropriate remedial or disciplinary sanctions. By

disciplining incompetent and unethical practices, a PAB would improve the overall quality of the audit, review, and attest services.

4. *Improved transparency regarding the regulatory system.* In order for a PAB to earn investors' trust, investors must be able to view the PAB's regulatory system at work. Our proposals would not only encourage "real-time" reporting by the PAB of its regulatory activities, they also would open a PAB's disciplinary proceedings to the public to the same extent that our Rule 102(e) proceedings are public.<sup>159</sup> Open proceedings would shed light on a professional disciplinary process that the AICPA has conducted behind closed doors.

5. *Enhanced disclosure by corporate officers, directors, and director nominees of PAB sanctions.* We are proposing that investors be informed if an executive officer, director, or person nominated to become a director has been sanctioned as a member accountant by a PAB within the last five years. We anticipate that a PAB would initiate disciplinary proceedings in cases of incompetence, unethical behavior, or serious breaches of professional standards. Sanctions imposed following these proceedings, therefore, would be of interest to investors making investment or voting decisions.

6. *Improved cooperation among standard-setting bodies.* As noted by the Panel on Audit Effectiveness and others, one of the limitations of the current system is a lack of effective communications among the various entities involved in oversight of the audit process.<sup>160</sup> That Panel recommended that the profession's system of governance be united under a POB that oversees standard setting, monitoring, discipline, and supplemental reviews.<sup>161</sup> Our proposals reflect the need for greater communication and coordination among the participants of the regulatory system. Under our proposed rules, a PAB would either set, or rely on designated private bodies to set, audit, ethics, and quality control standards. To the extent that a PAB relies on others to set these standards, a PAB would oversee their efforts and encourage communication and coordination among them. In addition, a PAB would conduct periodic meetings with these bodies and include in those meetings the bodies that set accounting principles

<sup>159</sup> 17 CFR 201.102(e)(7).

<sup>160</sup> The Panel on Audit Effectiveness, *Report and Recommendations*, at 138–41 (Aug. 31, 2000).

<sup>161</sup> *Id.*

and other standards affecting the accounting profession. The primary purpose for these meetings would be to facilitate an understanding of one another's projects, which may lead to better coordinated and more efficient standard-setting within the profession.

We request comment on each of the items identified above. Would they result in higher quality audits? Would they result in enhanced investor protection and investor confidence? Would the proposed rules, if adopted, yield other benefits? Is it possible to quantify the benefits of the proposed rules?

Accountants and registrants also may benefit from a more coordinated and efficient regulatory process. As noted, our proposals would centralize into one independent body the quality control review functions previously performed by the POB and its staff, the SECPS's Peer Review Committee, the SECPS Executive Committee, the QCIC, and portions of the AICPA's disciplinary program. This body also would facilitate communications among various standard-setting bodies. We believe that a more efficient and leaner regulatory system, and a more coordinated standard-setting process, would benefit all participants in the financial reporting process. Among other things, we believe that these changes would reduce uncertainty about the regulatory and disciplinary system and would increase compliance.

The Commission seeks comment on the benefits of the proposed rule. What methods are available to estimate the benefits to investors and others that would result from a private sector regulatory scheme for accountants? We request comment, including supporting data if available, on these benefits, and commenters with quantitative or empirical data on these issues are invited to provide that data for our consideration.

### *C. Potential Costs of the Proposed Rules*

We are sensitive to the costs that might result from our rules. We believe that the costs related to the proposals in this release would fall within three general categories: costs that are similar to costs currently borne, incremental costs, and costs that will be redistributed among market participants. We recognize that redistributed costs are not mutually exclusive of costs already borne.

The proposal may result in costs similar to those already existing. SECPS member accounting firms already bear significant costs related to quality control reviews and to the POB-SECPS regulatory structure that administers

and oversees those reviews. We assume that those firms will cease to pay the SECPS to perform those functions once a PAB is in place and that the costs attendant to our proposals will be offset by that cost savings.<sup>162</sup> The proposed framework may result in incremental costs to small accounting firms that do not currently undergo quality control reviews, to Commission registrants, and to other accounting firms. Incremental costs could result from the performance of functions by a PAB that are performed today by no one. Finally, the proposal may result in redistributed costs. Funding for the FASB, for example, would not likely increase as a result of the proposals, but the burden might be redistributed from registrants and firms that make voluntary contributions to the FASB, or those that purchase a significant number of its publications, to all registrants and accounting firms that benefit from FASB's standards.<sup>163</sup>

We discuss each category of costs in more detail below in relation to the costs needed to fund a PAB (and the FASB), the imposition of costs on accounting firms and registrants, and the costs of preparing disclosure.

The proposed rules would entail costs to a PAB for its operations. Our proposals would leave many facets of a PAB's operations to its discretion. It is difficult, therefore, to estimate the budget that would be required to fund a PAB's full range of activities. Nonetheless, to estimate the funds that a PAB may require, we examined the budgets of other accounting regulatory bodies. The FAF, for example, has approximately 140 employees and reported 2001 net operating revenues of \$22,137,000. The POB was smaller, with five part-time board members, a permanent staff of five full-time professional employees, seven part-time professional employees, and two administrative employees. The POB's annual budget, without special projects, was approximately \$3,500,000, although under the February 2001 charter, the POB could have increased its budget to \$5,200,000 per year. The POB Chairman received \$70,000 per year, the Vice Chairman \$60,000, and members \$50,000.

<sup>162</sup> Because a PAB would have discretion in determining the nature and extent of procedures to be performed each year, we cannot reliably estimate what those additional costs may be.

<sup>163</sup> We recognize that some portion of the voluntary contributions may be derived from fees paid by registrants to their auditors. Direct payment by registrants may lead to reduced audit fees or a decrease in the rate of audit fee increases. To that extent, our proposals should have no redistributive effects.

The ISB, which from 1997 to 2001 undertook the development of auditor independence standards, had a part-time board of eight members, three full-time staff and one administrative employee. The annual budget for the ISB was approximately \$2,000,000 to \$2,200,000.

The SECPS has an annual budget of less than \$1,000,000, most of which relates to travel and lodging expenses. SECPS members are not compensated for their time, and except for a \$300,000 per year charge that the SECPS pays to the AICPA, the AICPA pays for the SECPS staff. The AICPA annual report, however, does not specifically provide the cost of its peer review program.<sup>164</sup>

We recognize that a proposed PAB would not be identical to any of these organizations. They provide guidance, however, to the cost of a comparably-sized organization within the accounting profession. The FAF, for example, funds standard-setting organizations that conduct neither on-site reviews of the performance of accounting firms nor disciplinary proceedings. The FAF budget, however, might provide some evidence of the revenues needed to run an organization within the accounting regulatory system that has 125 to 150 employees and permanent facilities. The amounts paid to the FASB Chairman and FASB members also might provide an indication of the amount of compensation required to attract a full-time Chairman or Vice Chairman to a PAB.

The POB's budget undoubtedly would be too small to fund a PAB, due to the more "hands-on" approach that we believe a PAB would take when directing large firms' reviews, evaluating smaller firms' reviews, conducting supplemental reviews, conducting disciplinary proceedings, and improving communications and coordination among various standard-setting bodies. Even when the funds budgeted to the SECPS are added to the POB's budget, the total amount might underestimate the amount required for a PAB due to the SECPS's reliance on volunteers from the accounting firms and on the payment of certain expenses by the AICPA. We anticipate that the cost of a PAB would be at least as much as the cost to run the POB and the SECPS, plus the cost of services provided to those organizations by volunteers. Moving these costs to a PAB would not result in an incremental cost.

<sup>164</sup> The AICPA notes expenses related to "professional examinations" of \$12,121,000, but it is unclear what amounts are included in this category. AICPA, *Annual Report 2000-2001*, at 26.

Incremental costs may occur, however, from the performance of additional functions. Because our proposal leaves the identification of, and procedures for, these functions to the discretion of a PAB, we cannot quantify those costs.

We anticipate that quality control reviews by a PAB would entail greater costs than those for quality control reviews by the POB. A PAB, for example, may incur significant costs to visit the offices of accounting firms during quality control reviews. If a PAB were directing a review, a PAB member or staff would conduct on-site visits to numerous and widely-dispersed offices of the accounting firm. Even if a PAB were not directing a quality control review but monitoring the review for its thoroughness and impartiality, we expect that a PAB or its staff would attend conferences between the reviewer and the firm being reviewed, and conduct on-site inspections during the conduct of the review. Fees to recover these costs, however, would be assessed separately from the more general fees imposed on all registrants and firms. As noted, we have proposed that each firm pay the cost of its own quality control reviews, as they do under the SECPS peer review system. To the extent that the cost of a PAB directed or approved quality control review exceeded both the cost of a peer review under the current SECPS peer review system and the cost of professional services donated to the SECPS and its committees, it would be an incremental cost. At this point, however, we are unable to quantify that cost. We also anticipate that incremental costs may result from a PAB conducting disciplinary hearings, preparing records of proceedings, and monitoring compliance with sanctions.

A PAB may incur costs attendant to an open and deliberative standard-setting process. These costs may include hiring staff who are experts not only in a given subject area, but also experts in drafting standards. These costs may also include hiring staff for the preparation and publication of standards. If a PAB elects not to set standards but to designate other private sector bodies to set them, a PAB would incur costs related to its oversight of those bodies, including costs related to reviews of their standards and other documents.

Finally, a PAB would have costs associated with our oversight. The preparation of an initial application and ongoing public reports, keeping quality control review records for our inspection, and preparing reports and records of disciplinary proceedings so we may review the sanctions imposed

by a PAB, among other things, would add to a PAB's costs.

#### Costs To fund the FASB Through a PAB

Our rules would impose costs on a PAB to fund the FASB. The revenues and expenses of the FASB are generally known. According to the 2001 Annual Report published by the FAF, the FASB received contributions of \$5,113,000, sold subscriptions and publications for \$14,818,000, and had direct costs of sales of \$1,586,000. The FASB, therefore, had revenues of \$19,931,000 and revenues minus costs of sales equal to \$18,345,000. The FASB and the GASB, also overseen and financed through the FAF, had combined net operating income of \$22,137,000. The FAF Annual Report does not break out expenses between the FASB and GASB, but it reports total program expenses of \$18,345,000 and total support expenses of \$4,883,000, for total expenses of \$23,228,000 and a combined operating loss (*i.e.*, revenues minus expenses) of \$1,091,000. The FAF Annual Report also notes a decline in investments and unrestricted net assets of \$2,342,000, from \$28,812,000 to \$26,470,000. The FAF has indicated to our staff that it has 141 employees, with 65 assigned to the FASB, 25 assigned to the GASB, and 51 assigned as FAF administrative support staff for both the FASB and GASB. We understand that the FASB Chairman is paid \$535,000 per year and that each of the other six full-time FASB members receive \$435,000 per year.

An estimate of the funds that a PAB would have to collect each year for the FASB, therefore, might range from \$20 million to \$24 million. Some registrants and accounting firms (the two groups that would pay fees to fund the FASB under our proposals) already bear these costs through voluntary contributions and purchases of FASB publications. The proposals, however, might result in a more even redistribution of these costs among all registrants and accounting firms, not simply those wishing to make contributions or purchase large volumes of publications. We believe that by spreading the costs more evenly, we would enhance investor confidence by promoting a system whereby those with an interest in the system do not have a larger role in funding it. In any event, the fees an accounting firm or registrant would pay to a PAB to fund the FASB would be largely offset by reductions in contributions to the FASB and the elimination of costs for FASB's publications.<sup>165</sup>

<sup>165</sup> Our proposal anticipates full funding for the FASB, with the FASB appropriately reducing or eliminating the cost of its publications. We have

We invite comment and data on estimated revenues needed by a PAB to conduct the programs described in this release and our proposed rules. Are our estimates correct? We also seek comment on the extent to which those costs would be incremental costs, and the extent to which the funding costs may be redistributed among various market participants. We request comment on the costs that would be imposed on a PAB to fund the FASB. Are our estimates correct?

#### Imposition and Distribution of Costs Incurred by Accounting Firms and Registrants

This section of the cost-benefit analysis discusses how the costs imposed by the proposal would be distributed among accounting firms and registrants. Under our proposal, the costs to fund a PAB and the FASB would be paid through fees assessed by a PAB. We expect a PAB to assess such fees according to schedules that apportion fees based on relative size of accounting firms and registrants such that fees would not be significant to any one entity. We also expect each accounting firm to continue to pay the costs of its own quality control reviews.

As noted, accounting firms and registrants currently bear the costs associated with the self-regulatory system. Both accounting firms and registrants make contributions to the FASB and buy FASB publications. Accounting firms pay fees to the SECPS and other organizations to fund the current peer review and professional standard-setting processes, and they pay the costs of their own peer reviews. Registrants pay increased audit fees to compensate accounting firms for conducting peer reviews and for other professional expenses. To the extent that a registrant or accounting firm makes donations to the FASB or purchases FASB publications, a reduction in those amounts would offset the new fees paid to a PAB. To the extent that the SECPS and other organizations no longer would perform peer reviews or conduct similar programs after a PAB begins operations, the reduction in costs associated with the SECPS self-regulatory system would offset new costs imposed by the PAB. These offsets would reduce the net or incremental cost of a PAB-based system.

Not all SECPS members would be members of a PAB. Of approximately 1,250 SECPS members, we estimate that

requested comment, however, regarding whether the FASB should continue to generate revenues from the sale of its publications, and replace only the donations it receives with fees collected by a PAB.

approximately 850 audit the financial statements of Commission registrants and approximately 400 do not. All 1,250 firms now contribute to the SECPS budget of approximately \$1 million and to the POB's budget of approximately \$3.5 million. Because 400 of the SECPS member firms would not be required to join a PAB, any amounts paid by those 400 firms might have to be borne by accounting firm and registrant members of a PAB, to the extent a PAB performs similar functions.

We also estimate that approximately 80 domestic small accounting firms that audit the financial statements of Commission registrants are not members of, and do not pay fees to, the SECPS or the AICPA. Amounts paid by these 80 firms to a PAB, therefore, would not be offset by reduced payments to the SECPS or AICPA. We expect, as noted, that a PAB would assess fees based on an entity's size or other relevant criteria. These firms, however, for the first time, may incur costs related to the conduct of quality control reviews. Because of the relatively small size of these firms, we anticipate that large, automated quality control systems would not be necessary. Nonetheless, the incremental costs of establishing controls and preparing and paying for reviews may be significant to a small firm. Some of these costs might be passed on or redistributed to the firm's audit clients that are Commission registrants, but such a redistribution would not affect the aggregate incremental cost of these firms' reviews.

In addition to the approximately 850 accounting firms that would be members of a PAB, approximately 16,242 public companies and 5,587 investment companies, as adjunct members, would pay fees to a PAB.<sup>166</sup> By creating a base of at least 20,000 paying adjunct members,<sup>167</sup> a PAB

should be able to construct a fee schedule that is fair and equitable. Assuming that the FASB and a PAB each would require \$20 million to fund its administrative functions and operations, an average of approximately \$2,000 per member and adjunct member would be assessed. Larger registrants and firms would be assessed significantly larger amounts; smaller firms and registrants would pay less.

Finally, we believe that certain firms would face costs in maintaining a central office function. Many firms already have procedures for consultation with a central office and resolution of differences of opinion between the central office and other offices. The rule would require a PAB to ensure that member firms maintain this function. Those firms that do not currently do so, therefore, could face costs to establish and maintain a central office function that would likely not be offset from any other source.

We solicit comments on the potential costs that would be imposed on registrants and accounting firms. What types of additional costs might be incurred? For example, if an accounting firm currently does not have a central office function, what would be the costs associated with creating and maintaining one? We seek comment on our assumptions about which costs would be offset and which would be incremental costs. Is it possible to quantify the costs discussed? We solicit quantitative data to assist in our assessment of the compliance costs related to a PAB.

Our proposal would result in differences in the timing and conduct of quality control reviews of those accounting firms with more than 70 SEC Clients and those with 70 or fewer SEC Clients. From a cost-benefit perspective, is this an appropriate dividing line? If not, what should be the cutoff, if any? We solicit any quantitative data that may be helpful in making this determination. We also request data on whether such costs would be costs that already are being borne by the accounting profession or others, incremental costs, or a redistribution of costs among market participants.

#### Costs of Complying With Collections of Information

The proposed rules would impose costs associated with disclosure, record retention, notice, and other information collection requirements. For purposes of

the Paperwork Reduction Act, we estimated the number of burden hours that would be incurred by a PAB, accountants, audit clients, and registrants as a result of the proposed rules. This "paperwork burden" is described in detail in Section V. of this release.

A PAB would incur costs as a result of complying with the information collection requirements in the proposed rules. These requirements are discussed in detail in Section V., above. Solely for the purposes of the Paperwork Reduction Act, we estimated that a PAB would incur 10,140 burden hours as a result of the proposed rules. Certain of these burden hours, specifically those associated with an initial submission to the Commission would be non-recurring costs for any PAB. All other burden hours would recur annually. We estimate that of the total burden hours, 75% of them would be incurred by the in-house staff of a PAB and 25% of them would be incurred by outside counsel. Assuming a rate of \$100 for in-house staff, a PAB would incur a cost of \$760,500 for in-house work. Assuming a rate of \$300 for outside counsel, a PAB would incur a cost of \$760,500 for work performed by outside counsel. Under these assumptions, a PAB would therefore expend approximately \$1,521,000 on paperwork requirements.

Accountants also would incur costs as a result of complying with collection of information requirements that would be imposed by the proposed rules. These requirements are discussed in detail in Section V, above. Solely for purposes of the PRA, we estimated that accountants would incur 4,530 burden hours as a result of our proposed rules. As discussed above, we estimated that as many as approximately 15 of these hours might be incurred by audit clients as opposed to accountants. We estimate that 75% of the 4,530 hours would be incurred in-house, and that 25% would be incurred by outside counsel. Based on staff experience, we estimate that the hours expended in-house by accountants would cost approximately \$100 per hour. We estimate that outside legal work would cost \$300 per hour. Under these assumptions, the in-house hours would result in a cost of \$339,750 and the hours incurred by outside counsel would result in a cost of \$339,750. Thus, the cost to accountants of information collection requirements would be \$679,500.

Finally, registrants would incur costs in complying with a new disclosure requirement under the proposed rules. Registrants would be required to make disclosure if a director, person nominated to be a director, or executive

<sup>166</sup> According to OMB Active Information Collections as of April 30, 2002, the following number of responses are submitted annually on the following forms: Form 10-K—10,381; Form 10-KSB—3,641; Form 11-K—774; Form S-1—3,617. We estimate that only 40 percent of the filers on Form S-1 will include financial statements and that the remainder are reporting companies making repeat filings. Therefore, to avoid duplication in determining the number of registrants filing financial statements with the Commission, we have reduced this number to 1,446 ( $3,617 \times .4$ ).

<sup>167</sup> If the Commission determines to include the approximately 865 investment advisers, 8,100 broker-dealers, 950 transfer agents, and the auditors of their financial statements within the scope of the rules, this base may be significantly expanded. In addition, a PAB might determine to assess fees to investment companies based on the numbers of portfolios, in the case of mutual funds and unit investment trusts other than insurance company separate accounts, and sub-accounts, in the case of insurance company separate accounts. Currently, there are approximately 8,364 portfolios of open-

end management investment companies, 14,451 sub-accounts of insurance company separate accounts, and 9,940 portfolios of unit investment trusts other than insurance company separate accounts.



officer was, in his or her capacity as a PAB member accountant, sanctioned by a PAB for violations of professional standards or the rules or membership requirements of the PAB within the previous five years, and that sanction has not been subsequently reversed, suspended, or vacated. For purposes of the PRA, we estimated that registrants would incur 30 burden hours per year in connection with this proposed rule. Thus, registrants would incur a cost associated with the 30 hours per year spent on the proposed disclosure requirement. We solicit comments on the costs of complying with the collections of information requirements that would be imposed by the proposed rules.

#### *D. Request for Comments*

We request comment on all aspects of this cost-benefit analysis. Would the primary benefits of the proposal be enhanced investor confidence and corporate governance? Are there other significant benefits we have not discussed? Are we correct in our assumption that the proposal would entail costs similar to those already incurred, incremental costs, and redistributed costs? Are there other categories of costs we have not discussed? To assist the Commission in its evaluation of the costs and benefits that may result from the proposed rules discussed in this release, we request that commenters provide views and data relating to any costs and benefits associated with the proposed rules. Is it possible to quantify the costs and benefits discussed? What methods should we employ in attempting to place values on the costs and benefits?

#### **VII. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation**

For the purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>168</sup> we are requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commenters should provide empirical data to support their views.

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact on competition of any rule we adopt. The proposed rules are intended to create a framework for a new, independent, private-sector regulatory structure for oversight of accountants who audit or review financial

statements, or prepare attestation reports, filed with the Commission. We have identified two possible areas where the proposed rules could place a burden on competition. A possible impact on competition could occur as a result of: (1) Accountants and registrants being members and adjunct members, respectively, of a PAB in order to satisfy conditions necessary to make financial statements and attestation reports acceptable for filing with the Commission, and (2) new costs placed on small accounting firms that currently are not subject to periodic quality control reviews. To the extent that a PAB uses fee schedules based on the relative size of registrants and accounting firms, we would expect that there would not be a significant burden imposed on a substantial number of small accounting firms and small registrants.

Any competitive impact stemming from membership of accountants in a PAB in order to provide audit, review, or attest services to a Commission registrant must be balanced against the need for investors to have confidence in the quality of audits and in the integrity of the financial information that fuels our securities markets. As noted above, accountants are assigned critical roles under the securities laws and our regulations, including reviewing and certifying financial statements and reporting their opinions on those statements directly to investors. If investors do not believe in the integrity and competence of the accountants providing those opinions, then investors might lose faith in the integrity of reported financial information and lose confidence in our markets. Our rule proposals are intended to provide a structure for a regulatory system that would foster the confidence of investors.

As noted in our cost-benefit analysis, firms that currently do not undergo periodic quality control reviews would have additional costs related to those reviews.<sup>169</sup> We estimate that this could occur for approximately 80 audit firms who are not currently members of the SECPS. These additional costs might also lead to an impact on competition. Under our proposals, these same audit firms with relatively few SEC clients would be members of a PAB. The imposition of PAB-related costs might lead to higher audit fees by these firms,

eroding their ability to compete for the provision of audit services with larger audit firms. Alternatively, these audit firms with relatively few SEC clients may choose to withdraw providing services to SEC registrants in order to avoid these additional costs. This may also result in less competition for the provision of audit services to some set of smaller SEC registrants.

We request comment regarding the degree to which our proposal would have harmful competitive effects on such small firms. We also request comment on any indirect effects on these firms' audit clients, including whether these costs might discourage some companies from making an initial public offering or entering our securities markets.

Section 2(b) of the Securities Act,<sup>170</sup> section 3(f) of the Exchange Act,<sup>171</sup> and section 2(c) of the ICA,<sup>172</sup> require us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. We believe that the proposed rules would promote market efficiency and capital formation by enhancing confidence in the financial information provided by registrants and examined or reviewed by accountants. Investors would have more confidence that: (1) Accounting firms' quality control systems reasonably assure the performance of high quality audit, review, and attest services and that individual accountants are adhering to those systems; (2) incompetent or unethical accountants are being identified and appropriately disciplined; and (3) there are direct lines of communication between quality control reviewers who discover problems with audit, quality control, ethics, or other standards and the body or bodies that can change those standards.

The possible effects of our rule proposals on efficiency, competition, and capital formation are difficult to quantify. We request comment on these matters in connection with our proposed rules.

#### **VIII. Initial Regulatory Flexibility Act Analysis**

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates

<sup>168</sup> Pub. L. No. 104–121, tit. II, 110 Stat. 857 (1996).

<sup>169</sup> As noted in our cost-benefit analysis, even firms that currently undergo SECPS reviews may incur incremental costs associated with PAB quality controls. Because a PAB would have discretion in determining the nature and extent of procedures to be performed each year, we cannot reliably estimate what those additional costs may be.

<sup>170</sup> 15 U.S.C. 77b(b).

<sup>171</sup> 15 U.S.C. 78c(f).

<sup>172</sup> 15 U.S.C. 80a–2(c).

to proposed revisions to rule 1-02<sup>173</sup> and rule 2-01<sup>174</sup> of Regulation S-X, the proposed addition of Rules 13-01 through 13-07 to Regulation S-X, and proposed revisions to Item 401 of Regulation S-K.<sup>175</sup> The proposals would create the framework for a new private sector regulatory structure for oversight of accountants that audit or review financial statements, or prepare attestation reports, that are filed with the Commission.

#### A. Reasons for the Proposed Action

In the wake of recent corporate failures that caused significant losses to investors and pensioners, Congress, the Commission, and others have been examining longstanding deficiencies in the accounting profession's self-regulatory programs. During this examination, the POB, which had overseen the profession's programs since 1977, voted to disband, leaving the profession without its "conscience and critic."<sup>176</sup> The consequences of not remedying the problems we have outlined in more detail above are significant to the quality of the audit process and the reliability of the financial information disseminated to investors. We have continuing concerns about the oversight of the accounting profession, including the effectiveness of the quality control review process. Without rules such as those we are proposing today, we are concerned that effective oversight will not be accomplished.

#### B. Objectives

Our objective is to lay the foundation for a new, stronger system of private sector regulation that would enhance investors' confidence in the audit process and in the reliability of the financial information used to make voting and investment decisions. Our proposals, among other things, would facilitate the formation of a stronger and more independent system of private sector regulation that would enhance investors' confidence in the quality of the audit process and in the integrity of reported financial information. The system, among other things, would:

- Move the system of regulation outside the AICPA and place it within the control of the representatives of public;

- Provide for more Commission oversight of the audit quality control process;
- Subject to periodic quality control reviews accounting firms that audit or review registrants' financial statements or provide attestation reports;
- Establish a consistent source of funds for the regulatory and accounting standard-setting processes, which is not dependent on voluntary contributions by the accounting profession;
- For larger firms, replace "firm-on-firm peer reviews" with PAB-directed reviews and assure that reviews of smaller firms' quality controls are conducted under programs that, among other things, are approved by a PAB, use a PAB's procedures, and provide for a PAB evaluation of each review; and
- Give the PAB the ability to discipline, in a public forum, accounting firms and individual accountants for incompetent or unethical conduct, or other violations of professional standards, and to discipline accounting firms for not having sufficient quality control systems or not complying with them.

Under the proposed rules, an SEC registrant's financial statements would not comply with Commission requirements unless the accountant who audited or reviewed those statements is a member of a PAB. Attestation reports would not comply with Commission requirements unless prepared by outside accountants who are members of a PAB. Furthermore, an SEC registrant's financial statements and attestation reports contained in or accompanying an SEC registrant's reports or registration statements would not comply with Commission requirements unless the registrant is an adjunct member of, and thereby bound to cooperate in any review or proceeding commenced by, the same PAB as its accountant.

A PAB would oversee the quality of financial statements relied on by investors by, among other things, administering a program of periodic reviews of accounting firms' quality controls and, when appropriate, disciplining accountants for deficiencies noted during those quality control reviews or that otherwise come to a PAB's attention. A PAB also would set, or rely on designated private sector standard-setting bodies to set audit, quality control, and ethics standards, and to facilitate communications among these bodies and others. To be recognized by the Commission, a PAB would be required to meet the conditions specified in the proposed rules, including having a board dominated by individuals who are not

members of the accounting profession, and being subject to the Commission's oversight.

Disclosure would be required in Commission filings if an executive officer, director, or director nominee had been, in his or her capacity as a PAB member accountant, sanctioned as a member accountant by a PAB within the previous five years and that sanction had not been reversed, suspended, or vacated.

#### C. Legal Basis

We are proposing the rule amendments and new rules under the authority set forth in Schedule A and Sections 2, 4, 5, 6, 7, 8, 10, 11, 19, and 28 of the Securities Act; Sections 2, 3, 9, 10, 10A, 12, 13, 14, 15, 17, 23, and 36 of the Exchange Act; Sections 5, 10, 14, and 20 of the PUHCA; Sections 304, 305, 307, 308, 309, 310, 314, and 319 of the Trust Indenture Act of 1939 ("Trust Indenture Act"); Sections 6, 8, 20, 30, 31, and 38 of the ICA; and Sections 203, 206A and 211 of the Advisers Act.

#### D. Small Entities Subject to the Proposed Rules

The proposals would affect small registrants and small accounting firms that are small entities. Exchange Act Rule 0-10(a)<sup>177</sup> and Securities Act Rule 157<sup>178</sup> define a company to be a "small business" or "small organization" if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that, as of February 20, 2002, approximately 2,500 companies were small entities, other than investment companies.

For purposes of the ICA, Rule 0-10<sup>179</sup> defines "small business" to be an investment company with net assets of \$50 million or less as of the end of its most recent fiscal year. We estimate that, as of May 17, 2002, approximately 225 investment companies met this definition.<sup>180</sup>

Our rules do not define "small business" or "small organization" for purposes of accounting firms. The Small Business Administration defines small business, for purposes of accounting firms, as those with under \$6 million in annual revenues.<sup>181</sup> We have only limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than \$6 million in revenues that

<sup>173</sup> 17 CFR 210.1-02.

<sup>174</sup> 17 CFR 210.2-01.

<sup>175</sup> 17 CFR 229.401.

<sup>176</sup> *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Mar. 19, 2002) (statement of Charles A. Bowsher, Chairman, Public Oversight Board, Former Comptroller General of the United States).

<sup>177</sup> 17 CFR 240.0-10(a).

<sup>178</sup> 17 CFR 230.157.

<sup>179</sup> 17 CFR 270.0-10.

<sup>180</sup> See *Proposed Amendments to Investment Company Advertising Rules*, Release No. 33-8101 (May 17, 2002), at n.142, 67 FR 36712 (May 24, 2002).

<sup>181</sup> 13 CFR 121.201.

practice before the Commission. We request comment on the number of accounting firms with revenue under \$6 million.

Our rules do not define “small business” or “small organization” in terms of private sector regulatory organizations such as a PAB. Because no such entity exists at this time, we cannot reliably estimate its revenues or expenses. In addition, we cannot know in advance whether more than one PAB would exist, and if so, whether one PAB may be a small entity while another would not be a small entity. A PAB, however, would collect fees to fund not only its own operations but also approximately \$20 to \$24 million to fund the FASB. It would appear, therefore, that based on its revenues and scope of operations a PAB would not be a small entity.

We request comment on whether a PAB would be a small entity. What criteria should be used to make this determination? If more than one PAB is formed and recognized by the Commission, is it likely that there would be both small and large PABs?

#### *E. Reporting, Recordkeeping and Other Compliance Requirements*

The proposed rules would affect small accounting firms and small audit clients of accounting firms.

##### **Registrants**

The proposed rules would impose minor reporting, recordkeeping, and compliance requirements on small entity registrants related to the operations of a PAB.

Registrants would provide testimony and documents, upon request, to a PAB. The proposed rules do not direct a registrant, however, to keep or prepare documents or to maintain them in any specific form. Any burden under the proposals would relate to releasing documents and providing testimony to the PAB in supplemental reviews and disciplinary proceedings against the registrant’s accountant. Although we cannot estimate at this time how often these events would occur, we do not expect this burden to have a significant economic impact on a substantial number of small entities.

Registrants would pay fees assessed by a PAB and, through increased audit fees, might pay for increased costs incurred by accounting firms, as discussed below. We anticipate that a PAB would impose fees based on the relative size of registrants and accounting firms, such that the fees would not be significant to any one entity. Possible increases in audit fees also should not be significant. As noted

below, and in our cost-benefit analysis, many accountants already undergo periodic quality control reviews. For small firms currently participating in these programs, the incremental costs should not be significant. For small accounting firms not currently participating in these programs, the incremental costs may be greater and a firm may attempt to pass these costs to a registrant-audit client. Even these firms, however, as explained below, currently must have a quality control system in place. The direct and indirect incremental fees imposed on small registrants, therefore, should not have a significant economic impact on a substantial number of small registrants.

We also have proposed a disclosure requirement in Regulation S–K for registrants with an executive officer, director, or director nominee who, in his or her capacity as a PAB member accountant, was sanctioned by a PAB during the past five years. The information required to make this disclosure, when necessary, would be readily available from the individual and from a PAB’s public reports. The proposed rules, therefore, would impose very low incremental costs, if any, for the collection and retention of information. In addition, in the relatively rare instances where the information would be disclosed, we anticipate that it would consist of no more than a few lines in a document and that drafting, reviewing, filing, printing, and dissemination costs, therefore, would be insignificant.

In addition, we have not added this disclosure requirement to Regulation S–B,<sup>182</sup> which, in lieu of Regulation S–K, is the source of disclosure requirements for “small business issuers.”<sup>183</sup> A small business issuer is one that has revenues of less than \$25 million, is a U.S. or Canadian issuer, is not an investment company, and, if a majority owned subsidiary, has a parent that also is a small business issuer.<sup>184</sup> Accordingly, the disclosure requirement should not impose a significant economic impact on a substantial number of small registrants.

We request comment on the reporting, recordkeeping, and other compliance requirements applicable to small entity registrants. Please quantify, if possible, what the likely burden would be.

##### **Accountants**

The proposed rules might impose incremental costs on some small accounting firms. These costs may be

offset, however, by reductions in costs currently paid to the SECPS and AICPA and amounts donated and paid to the FASB. In addition, many of these costs already are incurred to comply with requirements under GAAS to have an adequate quality control system.<sup>185</sup>

As noted in our cost-benefit analysis, the vast majority of firms practicing before the Commission already are involved in a peer review program. For these firms, any costs imposed by the proposed rules of maintaining quality control systems and having quality control reviews should be offset to a large degree by reductions of fees paid to the SECPS or to others for such reviews.

We have estimated, however, that approximately 80 domestic small accounting firms that audit the financial statements of Commission registrants are not members of the SECPS and do not participate in the SECPS peer review program. To the extent that such a firm does not participate in a peer review conducted by another organization, it may incur costs for the first time related to the conduct of quality control reviews. Because of the relatively small size of these firms, however, we anticipate that large, automated quality control systems would not be necessary.<sup>186</sup> We also note that these firms already likely incur costs related to the establishment and maintenance of a quality control system as required by GAAS, which states:

A firm of independent auditors needs to comply with the quality control standards in conducting an audit practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards in its audit engagements. The nature and extent of a firm’s quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.<sup>187</sup>

<sup>185</sup> See SAS No. 25, AU § 161.

<sup>186</sup> See, AICPA, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*, at 4, QC § 20.04, which states:

A firm’s system of quality control encompasses the firm’s organizational structure and the policies adopted and procedures established to provide the firm with reasonable assurance of complying with professional standards. The nature, extent, and formality of a firm’s quality control policies and procedures should be appropriately comprehensive and suitably designed in relation to the firm’s size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, the nature and complexity of the firm’s practice, and appropriate cost-benefit considerations.

<sup>187</sup> SAS No. 25, AU § 161.02 (as revised by SAS No. 96, Apr. 2002).

<sup>182</sup> 17 CFR 228.

<sup>183</sup> 17 CFR 228.10.

<sup>184</sup> 17 CFR 228.10(a)(1).

Nonetheless, we recognize that the costs of preparing and paying for reviews may be significant to a small firm. To address this concern, our proposals indicate that smaller firms would be required to have a review only once every three years, instead of the annual reviews required of larger firms.

We invite comments on the anticipated incremental costs to small firms of participating in the quality control review program discussed in this release. What would the reporting, recordkeeping, and other compliance costs be? Please quantify, if possible, any likely burden on small accounting firms.

In addition to paying costs associated with quality control reviews, accounting firms would pay fees imposed by a PAB to fund not only the PAB's operations but also the operations of the FASB. We expect, however, that a PAB would assess fees according to schedules based on an entity's size or other relevant criteria, such that the fees paid would not be significant to any one entity.

An accounting firm or individual accountant also might incur costs if the firm or individual becomes the subject of, or is required to participate in, a PAB's disciplinary proceedings. At this time, however, we cannot estimate the likely burden that would fall on small accounting firms as a result. In any case, we believe that they will not have a significant economic impact on a substantial number of small entities. We request comment on any likely burden that would result from disciplinary proceedings.

#### *F. Duplicative, Overlapping, or Conflicting Federal Rules*

We are not aware of any federal rules that duplicate, overlap, or conflict with the proposed rules.

#### *G. Significant Alternatives*

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

1. The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities;
2. The clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities;
3. The use of performance rather than design standards; and

4. An exemption from coverage of the proposed amendments, or any part thereof, for small entities.

Congressional proposals, suggestions made during the SEC Roundtables, the U.K. system of regulation of the accounting profession, and recommendations submitted by others have provided numerous alternatives for the regulation of the accounting profession.

After full consideration, we have included provisions in our proposed rules specifically designed to reduce the impact on small entities. We have provided for:

- A PAB to tailor fees based on a registrant's or accounting firm's size or other relevant criteria;
- Small firms to have triennial, as opposed to annual, quality control reviews; and
- Disclosure to be made by registrants complying with Regulation S-K, but not by small business issuers under Regulation S-B.

In drafting requirements for a PAB, we have made use of certain standards that set performance goals. A PAB would have the ability to design its rules, membership requirements, policies, and procedures to best achieve the goals discussed in this release.

Additional alternatives would be to exclude small entities from the rules or to provide an extended period of time for them to adhere to the rules. Because of the importance of high quality audits for all Commission registrants, we believe that small as well as large firms who audit public companies should be covered under the proposed rules.<sup>188</sup> We have not provided delayed implementation dates just for small firms because most firms currently are participating in a review program. We also believe that some time would be required for a PAB to be formed, adopt the appropriate rules and procedures, and hire the needed staff to begin to conduct reviews. This should give smaller firms sufficient time to prepare for those reviews.

#### *H. Solicitation of Comments*

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. Specifically, we request comment regarding the number of small entities that may be affected by the proposed amendments, the existence or

nature of the potential impact on those small entities, how to quantify the number of small accounting firms that would be affected by the proposals, and how to quantify the impact of the proposed amendments.

Commenters are requested to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules.

## **IX. Codification Update**

The Commission proposes to amend the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982):

By adding a new section 700, captioned "Matters Relating to a Public Accountability Board," to include the text in the adopting release that discusses the final rules, which, if the proposals are adopted, would be substantially similar to Section III of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

## **X. Statutory Authority**

We are proposing the rule amendments and new rules under the authority set forth in Schedule A and Sections 2, 4, 5, 6, 7, 8, 10, 11, 19, and 28 of the Securities Act; Sections 2, 3, 9, 10, 10A, 12, 13, 14, 15, 17, 23, and 36 of the Exchange Act; Sections 5, 10, 14, and 20 of the PUHCA; Sections 304, 305, 307, 308, 309, 310, 314, and 319 of the Trust Indenture Act; Sections 6, 8, 20, 30, 31, and 38 of the ICA; and Sections 203, 206A and 211 of the Advisers Act.

### **Text of Proposed Amendments**

#### **List of Subjects**

##### *17 CFR Part 210*

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

##### *17 CFR Part 229*

Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

<sup>188</sup> See, e.g., Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson, *Fraudulent Financial Reporting, 1987-1997, An Analysis of U.S. Public Companies* (1999); Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson, *Fraud Related SEC Enforcement Actions Against Auditors: 1987-1997* (2000).

**PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975**

1. The authority citation for part 210 continues to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 210.1-02 is amended by:

- a. Removing the authority citation following § 210.1-02;
- b. Redesignating paragraph (d) as paragraph (d)(1);
- c. Removing the period at the end of newly redesignated paragraph (d)(1) and in its place adding a colon; and
- d. Adding paragraphs (d)(2) and (d)(3).

The revision and additions read as follows:

**§ 210.1-02 Definition of terms used in Regulation S-X (17 CFR part 210).**

\* \* \* \* \*

(d)(1) *Audit (or examination).* \* \* \*

(2) *Review.* The term *review*, when used in regard to financial statements, means a review of the financial statements by an independent accountant in accordance with generally accepted auditing standards, as may be modified or supplemented by the Commission.

(3) *Attest or attestation.* The term *attest* or *attestation*, when used in regard to a report filed with the Commission pursuant to the securities laws or the rules or regulations thereunder, means a report by an independent accountant, on a written assertion that is the responsibility of another party, in accordance with Statements on Standards for Attestation Engagements, as may be modified or supplemented by the Commission, for purposes of issuing a report thereon.

\* \* \* \* \*

3. Section 210.2-01 is amended by redesignating paragraph (a) as paragraph (a)(1) and adding paragraph (a)(2) to read as follows:

**§ 210.2-01 Qualifications of accountants.**

\* \* \* \* \*

(a)(1) \* \* \*

(2) The Commission will not recognize any accountant as a certified

public accountant or a public accountant, or as independent with respect to an audit client, if, during the professional engagement period, the accountant is not a member accountant in good standing of a Public Accountability Board or if the audit client is not an adjunct member in good standing of the same Public Accountability Board, as those terms are defined in § 210.13.

\* \* \* \* \*

4. Section 210 is amended by adding an undesignated center heading and §§ 210.13-01 through 210.13-07 to read as follows:

**Article 13—Public Accountability Boards**

Sec.

- 210.13-01 Financial statements and attestation reports.
- 210.13-02 Definitions.
- 210.13-03 Commission recognition of Public Accountability Boards.
- 210.13-04 Conditions of Commission recognition of Public Accountability Boards.
- 210.13-05 Confidentiality and immunity.
- 210.13-06 Exemptions.
- 210.13-07 Foreign accountants.

**Article 13—Public Accountability Boards**

**§ 210.13-01 Financial statements and attestation reports.**

(a) Audited or reviewed financial statements or attestation reports contained in or accompanying reports or registration statements filed with the Commission must be audited or reviewed, in the case of financial statements, or prepared, in the case of attestation reports, by an accountant that, throughout the professional engagement period:

- (1) Is a member accountant in good standing of a Public Accountability Board of which the registrant filing the report or statement is an adjunct member in good standing; and
- (2) Satisfies all other requirements prescribed by the federal securities laws and the rules and regulations thereunder concerning an accountant that audits, reviews, or prepares such a statement or report.

(b) [Reserved]

**§ 210.13-02 Definitions.**

For the purposes of this § 210.13:

(a) *Accountant* means an independent public or certified public accountant that audits or reviews financial statements filed with the Commission, or that prepares attest reports filed with the Commission pursuant to the securities laws or the rules or regulations thereunder. References to the accountant include any accounting

firm with which the certified public accountant or public accountant is affiliated.

(b) *Adjunct member in good standing* means an entity that is an adjunct member of a PAB and:

- (1) Is not delinquent in the payment of fees assessed by such PAB;
- (2) Is not delinquent in the production of documents of the adjunct member or of the adjunct member's management employees, requested by such PAB and relevant to a review or proceeding by such PAB as described in §§ 210.13-04(f) through (g);
- (3) Is not delinquent in providing testimony of the adjunct member or of the adjunct member's management employees, requested by such PAB and relevant to a review or proceeding by such PAB as described in §§ 210.13-04(f) through (g); and
- (4) Is not delinquent in using its best efforts to cause its non-management employees and agents to provide to such PAB any documents or testimony requested by such PAB and relevant to a review or proceeding by such PAB as described in §§ 210.13-04(f) through (g).

(c) A member or adjunct member of a PAB is *delinquent* when a PAB has provided public notice, in accordance with PAB rules consistent with § 210.13-04(d)(11), that:

- (1) With respect to payment of fees assessed by a PAB, the member or adjunct member has failed to pay the fees; or
- (2) With respect to producing documents or providing testimony requested by a PAB and relevant to a review or proceeding by such PAB as described in §§ 210.13-04(f) through (g):
  - (i) In the case of a PAB request made to a member accountant, the member accountant has failed to produce the documents or provide the testimony after any good faith legal objection to the request has, in accordance with such PAB's rules, been resolved in such PAB's favor; and
  - (ii) In the case of a PAB request made to an adjunct member, the adjunct member has failed to produce the documents or provide the testimony, or has failed to use its best efforts to cause any of its non-management employees or agents to produce the documents or provide the testimony, after any good faith legal objection to the request has, in accordance with such PAB's rules, been resolved in such PAB's favor.

(d) *Foreign accountant* means an accountant, including associated entities of United States domiciled accountants:

- (1) Whose place of residence and principal office is outside the United States and its territories; and

(2) Who is not licensed by any state or territory of the United States.

(e) *Member accountant in good standing* means an accountant that is a member of a PAB and:

(1) Either:

(i) Has not been barred, suspended, or otherwise sanctioned by a PAB; or

(ii)(A) Has been reinstated by the PAB after having been barred or suspended from membership with the PAB; or

(B) Has not been cited in a public notice by the PAB as being noncompliant with the terms and conditions of any remedial or disciplinary sanction, other than suspension or bar, imposed by the PAB; and

(2) Is not:

(i) Delinquent in the payment of fees assessed by the PAB of which it is a member;

(ii) Delinquent in the production of documents of the accountant, or of any of the accountant's employees or agents, requested by such PAB and relevant to a review or proceeding by such PAB as described in §§ 210.13–04(f) through (g); or

(iii) Delinquent in providing testimony of the accountant, or of any of the accountant's employees or agents, requested by such PAB and relevant to a review or proceeding by such PAB as described in §§ 210.13–04(f) through (g).

(f) *Public Accountability Board*, or PAB, means an entity organized in accordance with, and for the purposes described in, this § 210.13 that the Commission recognizes pursuant to §§ 210.13–03 and 210.13–04.

(g) *Professional engagement period* means the period of the engagement to audit or review the registrant's financial statements or to prepare a report filed with the Commission. The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements or to prepare an attestation report to be filed with the Commission) or begins audit, review, or attest procedures, whichever is earlier. The professional engagement period ends when the registrant or the accountant notifies the Commission that the registrant is no longer the accountant's audit client.

(h) *Professional standards* means generally accepted accounting principles, generally accepted auditing standards, generally accepted standards for attestation engagements, the Commission's auditor independence regulations, the standards of the Independence Standards Board, and any other standards related to the audit, review or preparation of financial

statements or accountant's reports that accompany or are contained in filings made with the Commission, including auditing, quality control and ethics standards issued by a PAB or by a standard-setting body designated as authoritative by a PAB, as may be modified or supplemented by the Commission.

(i) *SEC clients* means issuers making initial public offerings, registrants filing periodic reports with the Commission under the Securities Exchange Act of 1934 (except broker-dealers registered only because of section 15(a) of that Act (15 U.S.C. 78o(a)) or the Investment Company Act of 1940, and any other Commission registrant that a PAB, by rule, may include within that category for the purposes for which the term is used in this § 210.13.

#### **§ 210.13–03 Commission recognition of Public Accountability Boards.**

(a) To obtain Commission recognition as a PAB, an entity must submit for Commission review representations and materials on the basis of which the Commission can make a determination as to the entity's commitment and capacity to carry out the functions and to accomplish the purposes of a PAB as described in this § 210.13. Such submission shall include, at a minimum, the representations and materials described in paragraph (c) of this section.

(b) After receiving any submission pursuant to paragraph (a) of this section, the Commission shall, by order, determine whether the entity making the submission shall be recognized as a PAB. The Commission shall, consistent with the public interest and for the protection of investors, make its determination on the basis of the entity's commitment and capacity to carry out the functions and accomplish the purposes of a PAB as described in this § 210.13. Before making its determination, the Commission may ask the entity to supplement its submission with such materials, representations, or written answers to questions as the Commission determines are necessary for the Commission to make an appropriate determination in the public interest and for the protection of investors.

(c) Any submission pursuant to paragraph (a) of this section must include:

(1) The entity's organizational structure, proposed board members and terms of board membership, and proposed budget, sufficient to determine that the entity will satisfy the requirements set out in § 210.13–04(b);

(2) The entity's charter and bylaws, which shall satisfy the criteria described in § 210.13–04(c);

(3) Representations that the entity shall undertake to:

(i) Improve the quality of audit, review and attest services provided by its member accountants;

(ii) Improve the quality controls over member firms' accounting practices, auditing practices, and compliance with auditor independence and ethics regulations;

(iii) Enhance investors' confidence in the audit process; and

(iv) To the extent it relies on private sector bodies to set auditing, ethics or quality control standards, foster cooperation and coordination among such private sector bodies, both domestic and international, and among those private sector bodies and private sector bodies that set standards for accounting and independence;

(4) Representations that the entity shall put in place rules, membership requirements, systems and procedures designed to further the goals described in paragraph (c)(3) of this section and sufficient to accomplish, at a minimum, the objectives described in § 210.13–04(d); and

(5) A representation that the entity will study matters concerning the quality control systems of foreign accountants and periodically report to the Commission on whether, or under what conditions, the exemption concerning foreign accountants in § 210.13–07(a) should be withdrawn.

#### **§ 210.13–04 Conditions of Commission recognition of Public Accountability Boards.**

(a) *Conditions of recognition.*

Commission recognition of a PAB is conditioned upon the PAB satisfying the criteria described in paragraphs (b) through (i) of this section.

(b) *Organizational structure, board membership, and budget.* A PAB shall:

(1) Have a fixed number of board members:

(i) None of whom may be, or have been at any time in the two-year period immediately preceding his or her PAB term, an employee of any accountants' professional organization;

(ii) No more than one-third of whom, and in any event no more than three of whom, may:

(A) Be, or have been at any time in the ten-year period immediately preceding his or her PAB term, an accountant or a partner, principal, shareholder, or managerial employee of an accounting firm; or

(B) Be a retired partner, principal, shareholder, or managerial employee of

an accounting firm, eligible to receive benefits under an accounting firm's partner retirement plan or a comparable plan; and

(iii) The remainder of whom shall be designated as "public board members;"

(2) Have staggered terms for board members;

(3) Have a Chairman and Vice Chairman who are selected from among the public board members, and at least one of whom shall serve on a full-time basis; and

(4) Have the means, capacity and plan to obtain the resources to employ a professional staff that includes a sufficient number of professionals with expertise in the audit process and quality control reviews to structure and supervise the quality control reviews required under paragraph (f) of this section, to conduct the supplemental reviews and disciplinary proceedings described in paragraph (g) of this section, and to engage consultants and other representatives and advisers necessary to carry out the purposes of this § 210.13.

(c) *Charter and bylaws.* A PAB's charter and bylaws shall:

(1) Provide that the entity shall be a not for profit entity;

(2) Include quorum provisions that insure that the public board members will have the ability to control the outcome of any matter submitted to a vote of the board;

(3) Provide that the entity shall be subject to and shall act in accordance with Commission oversight as described in paragraph (i) of this section; and

(4) Provide that, immediately upon the effective date of any Commission rule abrogating, adding to, or deleting from the entity's rules, the entity's rules shall be deemed, without further action, to be amended as provided by such Commission rule.

(d) *Rules, membership requirements, systems, and procedures.* A PAB shall have in place rules, membership requirements, systems, and procedures designed to further the goals described in § 210.13-03(c)(3), and sufficient to accomplish, at a minimum, the following:

(1) Provide for membership enrollment procedures that:

(i) Minimize the administrative burden on individual accountants by maximizing the extent to which the enrollment requirements, and any periodic updating requirements, may be satisfied by an accounting firm on behalf of its individual accountants; and

(ii) Require members and adjunct members to agree to be bound by the PAB's rules and membership requirements;

(2) Require that member accountants maintain a system of quality control for the accountant's accounting and auditing practice designed to meet the requirements of quality controls set or designated as authoritative by the PAB, but encompassing, at a minimum, the requirements described in paragraph (e) of this section;

(3) Require member accountants to comply with their own system of quality controls in a manner that provides reasonable assurance of conforming with professional standards;

(4) Have a continuing program of review of each member firm's quality control systems concerning accounting practices, auditing practices, and adherence to Commission and professional auditor independence requirements; and administer that program according to the criteria described in paragraph (f) of this section;

(5) Direct member firms to make and keep for specified periods of time records that:

(i) Are required by professional standards in connection with each audit, review, or attest of a registrant's financial statements or reports; or

(ii) Otherwise document the procedures performed and the resolution of material issues during each audit or review engagement;

(6) Conduct supplemental reviews and disciplinary proceedings, in accordance with the criteria described in paragraph (g) of this section;

(7) Provide procedures for requesting and obtaining documents and testimony relevant to a review or proceeding by such PAB as described in §§ 210.13-04(f) through (g);

(8) Adopt appropriate policies to address any conflicts or potential conflicts of interest that may arise involving the PAB's board members, employees, contractors, and professional representatives;

(9) Collect from each registrant that is an adjunct member of the PAB, and from each member accounting firm, reasonable fees and charges, which fees may be assessed by the PAB according to schedules specifying different fees for different classes of registrants and accounting firms, sufficient:

(i) To fund the operation and administration of the PAB; and

(ii) To fund the operation and administration of an accounting standards-setting body endorsed by the Commission as the primary source for generally accepted accounting principles;

(10) Collect from each member accounting firm reasonable fees and charges sufficient to recover the costs

and expenses of conducting or overseeing quality control reviews of that firm as described in paragraph (f) of this section;

(11) Provide fair procedures for disciplining and sanctioning accountants and for resolving disputes with member accountants and adjunct members concerning fees, document requests and requests for testimony, including procedures providing for appropriate notice to the member accountant or adjunct member, the Commission, and the public of any action that could result or has resulted in suspension or bar of a member accountant or a loss of good standing by a member accountant or adjunct member;

(12) Set, or rely on designated private sector bodies to set, auditing, ethical or quality control standards for its members and, to the extent it relies on private sector bodies to set such standards, oversee such bodies and request that such matters as the PAB deems appropriate be added to the standard-setting agendas of such private sector bodies, and notify the Commission of each such request;

(13) Request that matters be added to the agenda of private sector bodies that set accounting or independence standards, and notify the Commission of each such request;

(14) Facilitate and participate in periodic meetings of representatives of the private sector bodies that set accounting, auditing, quality control, ethics and independence standards, representatives of the Commission, and such other persons as the PAB deems appropriate, for the purpose of furthering the coordination and cooperation among such bodies;

(15) Provide that the PAB's process for amending governing documents, rules, membership requirements and procedures shall include an open and deliberative rulemaking process with open meetings, the publication for public comment of draft rules, requirements and procedures and substantive consideration of those comments;

(16) Provide for extending full faith and credit to the sanctions and good standing requirements of any other PAB, such that an accountant sanctioned by, or an accountant or registrant in violation of the good standing requirements of, one PAB may not evade any sanction, inquiry, or failure of good standing by switching its membership to a different PAB;

(17) Provide or require training for accountants in matters related to accounting, auditing, attestation,



assurance, ethics, independence, and quality controls; and

(18) Perform such other duties or functions as shall be provided in any rule or order that the Commission may adopt or issue in furtherance of the public interest or for the protection of investors and to carry out the purposes of this § 210.13.

(e) *Quality control requirements.* A PAB shall require that each of its member accountants maintain a system of quality control for the accountant's accounting and auditing practice designed to meet the requirements of quality controls set or designated as authoritative by the PAB, including quality controls concerning independence, integrity, and objectivity; personnel management; acceptance and continuance of clients and engagements; engagement performance; and monitoring. The quality controls required by a PAB shall include, at a minimum:

(1) Assigning a new audit engagement partner to be in charge of an audit engagement that has had another audit partner-in-charge for a period of seven consecutive years;

(2) Establishing policies and procedures for a review of the audit report and financial statements by a partner other than the audit partner-in-charge of an audit engagement before issuance of an audit report on the financial statements and before the reissuance of such an audit report where performance of subsequent events procedures is required by professional standards, or alternative procedures that a PAB authorizes where this requirement cannot be met because of the size of the member firm;

(3) Ensuring policies and procedures are in place to comply with applicable auditor independence requirements and to refrain from performing consulting services that are inconsistent with § 210.2-01, and to refrain from conducting public opinion polls or merger and acquisition assistance for a finder's fee;

(4) At least annually, disclosing to the audit committee of each audit client that is a Commission registrant (or the board of directors if there is no audit committee), in writing, all relationships between the accountant and its related entities that in the accountant's professional judgment may reasonably be thought to bear on auditor independence; confirming in that letter that, in the accountant's professional judgment, it is independent of the registrant within the meaning of the securities laws, the rules and regulations thereunder, and professional standards; and discussing the

accountant's independence with the audit committee (or board of directors);

(5) When the member firm has been the auditor of the financial statements of a Commission registrant and has resigned, declined to stand for reelection, or been dismissed, promptly reporting in writing to the registrant, with a simultaneous copy to the Commission's Office of the Chief Accountant, the fact that the client-auditor relationship has ceased;

(6) For member firms that are associated with international firms or international associations of firms:

(i) Seeking the adoption of policies and procedures by the international organization or individual foreign associated firms that are consistent with the objectives of this § 210.13; and

(ii) Reporting annually, or more frequently as the PAB may prescribe, the name and country of the foreign associated firms, if any, for which the member firm has been advised in writing by its international organization or the individual foreign associated firms that such policies and procedures have been established;

(7) Ensuring that the member firm has policies and procedures in place to report to the PAB, with a copy of the report to the Commission's Office of the Chief Accountant, litigation or any proceeding or investigation by a government agency alleging either deficiencies in the conduct of an audit or review of financial statements filed with the Commission by a present or former audit client, or any other violation of the securities laws, within 30 days of service of the first pleading in the matter on the accountant or on any partner or employee of a member accounting firm;

(8) Ensuring that the member firm maintains a central office function that develops expertise in technical accounting and financial reporting matters, and has in place the following policies and procedures, or alternative procedures that a PAB authorizes where these requirements cannot be met because of the size of the member firm:

(i) Policies and procedures requiring, as appropriate, consultations with that office by engagement partners and others within the member firm; and

(ii) Policies and procedures for the resolution of differences of opinion between that central office and engagement partners; and

(9) Ensuring that the member firm has policies and procedures that require:

(i) Prompt notification to the firm when an individual accountant who is a partner or employee of the firm begins discussions with an audit client respecting possible employment; and

(ii) Review of that accountant's work on engagements for that client to determine whether changes in the audit plan or audit team are necessary and to assure adherence to the Commission's auditor independence rules.

(f) *Quality control review program.* A PAB shall administer and conduct a continuing program of quality control reviews and inspections of each member firm to assess compliance by such firm, and by individual accountants associated with such firm, with the rules and membership requirements adopted by the PAB, and professional standards, and shall administer such program according to the following criteria:

(1) A PAB shall annually conduct such a quality control review of each member accounting firm that audits or reviews the financial statements of more than 70 SEC clients, or such other number of SEC clients as the PAB by rule may determine, and shall conduct such a quality control review of all other member accounting firms at least once every three years;

(2) A PAB shall direct member firms to make and keep, for such periods as the PAB determines necessary, records that are necessary for the conduct of the quality control reviews required by this section;

(3) A PAB shall establish policies and procedures for conducting the quality control reviews, establish procedures for reporting of the results of the quality control reviews, and maintain public files for each member accounting firm containing recent quality control review reports on the firm and the firm's response to each report;

(4) A PAB shall provide for monitoring of the quality control reviews to ensure that they are conducted in a fair and impartial manner and for evaluating each quality control review and report to gain assurance that appropriate procedures are recommended and being implemented to correct noted deficiencies, if any, in a timely and effective manner;

(5) A PAB or its staff shall plan and direct all such quality control reviews, make all key decisions related to such quality control reviews, and perform all tasks necessary to conduct such quality control reviews, except that:

(i) A PAB may engage individual accountants from a firm or firms not associated with the firm being reviewed to assist in the conduct of such quality control reviews, provided that such accountants perform only assigned functions and are under the supervision of the PAB or its staff; and

(ii) Quality control reviews of member accounting firms that audit or review the financial statements of 70 or fewer SEC clients, or such other number of SEC clients as the PAB by rule may determine, may be conducted pursuant to quality control review programs approved by the PAB, provided any such quality control review program follows the PAB's policies and procedures and the PAB administers the program and performs the functions described in paragraphs (f)(2) through (f)(4) of this section;

(6) In conducting such quality control reviews, a PAB or, in the case of a quality control review program, the reviewer, shall review, among such other things as the PAB may determine, selected audit and review engagements performed at various offices and by various persons associated with the firm under review, and, in connection therewith, evaluate whether such firm's quality control system is appropriate, whether its policies and procedures are adequately documented and communicated to its personnel, and whether the firm is in compliance with such policies and procedures sufficient to provide reasonable assurance of conformity with Commission rules, PAB membership requirements and rules, and professional standards; and

(7) In connection with each quality control review, a PAB or, in the case of a quality control review program, the reviewer, shall prepare a report of its findings and comments, and such report, accompanied by any letter of response from the member firm, shall be made publicly available as specified in paragraph (f)(3) of this section.

(g) *Supplemental reviews and disciplinary proceedings.* (1) A PAB shall have rules, membership requirements, systems, and procedures, incorporating the criteria described in paragraphs (g)(2) through (g)(9) of this section, pursuant to which a PAB may:

(i) Institute public proceedings (hereinafter "disciplinary proceedings") to determine whether an accountant has engaged in any act or practice, or omitted to act, in violation of the rules or membership requirements adopted by the PAB or professional standards, and to impose remedial or disciplinary sanctions for any such act, practice, or omission; and

(ii) On the basis of information suggesting the possibility of any such act, practice, or omission, engage in a nonpublic practice of requesting and reviewing information (hereinafter "supplemental reviews") to determine whether to institute disciplinary proceedings;

(2) If a PAB, at any time, becomes aware of information indicating that a violation of the securities laws has or is likely to have occurred, then the PAB promptly shall notify the Commission of that information. A PAB may initiate a disciplinary proceeding regarding that information only after notifying and consulting with the Commission;

(3) A PAB shall establish fair procedures for supplemental reviews and for disciplinary proceedings. In any disciplinary proceeding, a PAB shall bring specific charges, notify such firm or person of those charges, give such firm or person an opportunity to defend against those charges, and keep a record. Disciplinary proceedings shall be public unless otherwise ordered by the PAB with the prior approval of the Commission;

(4) For purposes of supplemental reviews or disciplinary proceedings, a PAB may request that any person provide testimony or documents relevant to the review or proceeding;

(5) PAB board members who are not public board members may be consulted in connection with supplemental reviews and disciplinary proceedings but shall not have a vote in the PAB's determination whether to institute a disciplinary proceeding, what findings to make in a disciplinary proceeding, or what sanctions to impose;

(6) If, as the result of a disciplinary proceeding, a PAB finds that an accountant has engaged in any act or practice, or omitted to act, in violation of the rules or membership requirements adopted by the PAB or professional standards, then the PAB may impose any appropriate disciplinary or remedial sanctions including revocation or suspension of membership, or expulsion from, the PAB; limitations on activities, functions, and operations, including requiring a member firm to resign a specific audit, review or attestation engagement; suspending or barring an accountant from participating in any way in any audit, review or attest engagement for any Commission registrant; fine; censure; or any other appropriate sanction;

(7) Whenever a PAB imposes a disciplinary sanction against an accountant, the PAB shall report such sanction in writing to the accountant against whom the sanction is imposed, to the Commission, to the appropriate State or foreign financial regulatory authority or authorities with which such firm or such person is licensed, registered, or certified to practice public accounting, and to the public. Each PAB report shall include:

(i) The name of the accountant against whom the sanction is imposed;

(ii) A description of the acts or practices, or omissions to act, upon which the sanction is based;

(iii) The nature of the sanction; and

(iv) Such other information respecting the circumstances of the disciplinary action as the PAB deems appropriate;

(8) In the event that a PAB is unable to conduct or complete a proceeding under this section because of the refusal of any person to testify, produce documents, or otherwise cooperate with the PAB, the PAB shall report such refusal to the Commission. If the uncooperative party is a registrant, the PAB shall also report such refusal to any market or exchange where the registrant's securities are traded or listed. A PAB may refer any other matter to the Commission, as the PAB deems appropriate; and

(9) PAB rules shall require member accounting firms:

(i) To notify the PAB in the event that the member firm employs or becomes associated with an individual accountant during any period in which that individual accountant is subject to a sanction, order or ruling issued by a PAB; and

(ii) To undertake procedures to ensure that the individual accountant does not violate the terms of the sanction, order or ruling.

(h) *Public reporting.* A PAB shall report to the Commission and to the public at least annually, and where practicable on a current basis, the following matters:

(1) A detailed description of the quality control review and disciplinary activities of the PAB;

(2) The annual audited financial statements of the PAB;

(3) An explanation of the fees and charges imposed by the PAB on members and adjunct members;

(4) A summary of the issues addressed in the PAB-sponsored periodic meetings with, or in connection with its oversight of, private sector standard-setting bodies;

(5) A list of all matters the PAB referred to each private sector standard-setting body that were not placed on the agenda of that body within 90 days of the PAB's referral; and

(6) Such other matters as the PAB deems appropriate or the Commission, by order, requires.

(i) *Commission oversight.* A PAB shall consent to, and act in compliance with, Commission oversight as follows:

(1) The Commission, by rule, may abrogate, add to, and delete from the rules of a PAB as the Commission deems necessary or appropriate to

ensure the fair and efficient administration of the PAB, to conform its rules to requirements of the securities laws or the rules and regulations thereunder, or otherwise in furtherance of the purposes of the securities laws. The Commission shall notify the PAB of any such action prior to publication of the notice of proposed rulemaking in the **Federal Register**;

(2) The Commission staff periodically may inspect and monitor the operations, records, and results of a PAB to ensure the PAB is operating in the public interest and for the protection of investors and fulfilling the purposes of the Commission in adopting this § 210.13. A PAB shall make and keep records, reports and summaries of its activities that the Commission staff deems necessary for its inspection of the PAB's quality control review activities, supplemental reviews, and disciplinary proceedings. A PAB shall adopt a policy, which shall be subject to Commission approval by order, identifying the categories of records, reports, and summaries that it shall retain. A PAB shall adopt a policy that provides for the retention of such materials until such time as the Commission has either inspected the materials or informed the PAB that it need no longer retain the documents;

(3) The PAB shall, in accordance with paragraphs (g)(7) and (d)(11) of this section, promptly notify the Commission whenever it imposes any final disciplinary sanction on any member accountant or determines any member accountant or adjunct member to be delinquent. The Commission may review that sanction as follows:

(i) Any final PAB disciplinary action or delinquency determination shall be subject to review by the Commission on its own motion at any time, or upon application by any person aggrieved thereby filed within thirty days after the date the notice required by paragraph (g)(7) or paragraph (d)(11) of this section was filed with the Commission and received by such aggrieved person, or within such longer period as the Commission, by order, allows.

Application to the Commission for review, or the institution of review by the Commission on its own motion, shall not operate as a stay of such action unless the Commission otherwise orders, summarily or after notice and opportunity for hearing on the question of a stay (which hearing may consist solely of the submission of affidavits or presentation of oral arguments);

(ii) In any Commission proceeding to review a final disciplinary sanction imposed by a PAB on a member accountant, after notice and opportunity

for hearing (which hearing may consist solely of consideration of the record before the PAB and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction):

(A) If the Commission finds that the member accountant has engaged in such acts or practices, or has omitted such acts, as the PAB has found the accountant to have engaged in or omitted, that such acts or practices or omissions to act are in violation of such provisions of the securities laws, the rules or regulations thereunder, the rules or membership requirements adopted by the PAB, or professional standards as have been specified in the determination of the PAB, and that such provisions are, and were applied in a manner, consistent with the purposes of this § 210.13, then the Commission, by order, shall so declare and, as appropriate, affirm the sanction imposed by the PAB, modify the sanction in accordance with paragraph (i)(3)(iv) of this section, or, if appropriate, remand to the PAB for further proceedings; or

(B) If the Commission does not make the finding set forth in paragraph (i)(3)(ii)(A) of this section, it shall, by order, set aside the sanction imposed by the PAB and, if appropriate, remand to the PAB for further proceedings; or

(iii) In any Commission proceeding to review a PAB determination that a member accountant or adjunct member is delinquent, after notice and opportunity for hearing (which hearing may consist solely of consideration of the record before the PAB and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the determination):

(A) If the Commission finds that the member accountant or adjunct member has failed to comply with PAB rules or membership requirements concerning fee payments, requests for documents, or requests for testimony, that the PAB's determination is in accordance with the rules of the PAB, and that such rules are, and were applied in a manner, consistent with the purposes of this § 210.13, the Commission, by order, shall so declare and, as appropriate, affirm the delinquency determination, cancel the delinquency determination in accordance with paragraph (i)(3)(iv) of this section, or, if appropriate, remand to the PAB for further proceedings; or

(B) If the Commission does not make the findings set forth in paragraph (i)(3)(iii)(A) of this section, the Commission shall, by order, set aside the delinquency determination and, if appropriate, remand to the PAB for further proceedings; or

(iv) If the Commission, having due regard for the public interest and the protection of investors, finds after a proceeding in accordance with this paragraph (i)(3) that a sanction imposed, or a delinquency determination made, by the PAB imposes any burden on competition not necessary or appropriate in furtherance of the purposes of the securities laws or is excessive or oppressive, the Commission may cancel such delinquency determination or may cancel, reduce, or require the remission of such sanction;

(4) The Commission, by order, may remove from office or censure any board member of a PAB if the Commission finds, on the record after notice and opportunity for hearing, that such member has willfully violated any provision of the securities laws, the rules or regulations thereunder, or the rules of the PAB, willfully abused his or her authority, or without reasonable justification or excuse has failed to enforce compliance with any such provision or any professional standard by any accountant that is a member of the PAB.

(5) If the Commission finds that a PAB has failed or is failing to comply with any of the conditions of recognition described in this § 210.13–04, the Commission may, by order, withdraw recognition of such PAB and direct that any fees described in paragraphs (d)(9) and (d)(10) of this section and collected by, or due and owing to, such PAB shall be held in escrow pending:

(i) Resolution or correction of such PAB's failings, satisfactory to the Commission; or

(ii) A Commission order that such funds be paid to one or more other PABs that enroll members from the PAB that the Commission has ceased to recognize.

#### **§ 210.13–05 Confidentiality and immunity.**

(a) Because a PAB's nonpublic proceedings and deliberations are subject to Commission oversight, and are governed by this § 210.13 in furtherance of the purposes of the securities laws, including the enforcement of certain standards, the Commission finds that, except to the extent that such information is requested by the Commission, any other Federal department or agency, the appropriate State licensing authority or authorities, State criminal law enforcement authorities, and foreign governmental authorities or foreign financial regulatory authorities, it is in the public interest for a PAB:

(1) To be able to maintain the confidentiality of reports, memoranda

and other information prepared by it, and of its deliberations; and

(2) To claim confidentiality protection for its nonpublic reports, memoranda, other information prepared by it, and of its deliberations, to the full extent allowed by law.

(b) Because a PAB's activities are subject to Commission oversight, and are governed by this § 210.13 in furtherance of the purposes of the securities laws, the Commission finds that it is in the public interest for the PAB and its board members, employees, contractors, and professional representatives:

(1) To have immunity from private civil liability for any action or failure to act in connection with the PAB's responsibilities; and

(2) To claim immunity from private civil liability, for any action or failure to act in connection with the PAB's responsibilities, to the full extent allowed by law.

#### § 210.13-06 Exemptions.

(a) The Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt in whole or in part any accountant or any Commission registrant, or any class of accountants or Commission registrants, from any or all of the provisions of §§ 210.13 and 210.2-01(a)(2), if the Commission finds that such exemption is consistent with the public interest and the protection of investors.

(b) Accountants that do not audit or review financial statements or prepare attestation reports filed with the Commission on a recurring basis and whose audit reports are filed with the Commission only in accordance with § 210.3-05 are exempt from the requirements of this §§ 210.13 and 210.2-01(a)(2).

(c) The Commission, by rule or order, consistent with the public interest, the protection of investors, and the other purposes of the securities laws, may relieve a PAB of its responsibility to enforce compliance with any specified provision in § 210.13, the rules or membership requirements adopted by a PAB, or professional standards, with respect to any accountant, Commission registrant, or any class of accountants or registrants.

#### § 210.13-07 Foreign accountants.

(a) Any foreign accountant that audits or reviews financial statements filed with the Commission, or prepares reports that are filed with the Commission, and any foreign issuer that engages a foreign accountant for such services, shall be exempt from

compliance with §§ 210.13 and 210.2-01(a)(2).

(b) In reviewing the quality controls of any member firm that has associated entities that are foreign accountants, the PAB or reviewer should review the procedures performed by the member firm related to documents filed with the Commission that contain the reports or opinions of those foreign accountants.

#### PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S-K

5. The general authority citation for part 229 continues to read as follows:

**Authority:** 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll(d), 78mm, 79e, 79n, 79t, 80a-8, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), and 80b-11, unless otherwise noted.

\* \* \* \* \*

6. Section 229.401 is revised by adding paragraph (f)(7) before the Note to Paragraph (f) of Item 401 to read as follows:

#### § 229.401 (Item 401) Directors, executive officers, promoters and control persons.

\* \* \* \* \*

(f) \* \* \*

(7) Such person was sanctioned by a Public Accountability Board under § 210.13 of this Chapter for violations of professional standards or the rules or membership requirements of that Public Accountability Board and that sanction has not been subsequently reversed, suspended or vacated.

\* \* \* \* \*

Dated: June 26, 2002.

By the Commission.

**Margaret H. McFarland,**  
Deputy Secretary.

**Note:** Appendices A and B to the preamble will not appear in the Code of Federal Regulations.

#### Appendix A

##### Brief History of the Self-Regulatory System

The self-regulatory system established in September 1977 included the formation within the AICPA of a Division for CPA Firms and then the organization of that Division into two sections, one for those firms that audit financial statements filed with the Commission (the SECPS) and one for those that do not.<sup>189</sup> Since its formation,

<sup>189</sup> The section for those firms that do not audit Commission registrants was formerly called the

the SECPS has imposed membership requirements on firms and required member firms to participate in two programs intended to promote effective quality control systems. The first is a peer review program, which in recent years has involved firm on firm reviews.<sup>190</sup> The SECPS's Peer Review Committee administers the peer review program. The second program reviews allegations of audit failures involving Commission registrants that are contained in litigation filed against member firms. The QCIC conducts the second program.

The September 1977 resolution of the AICPA Council that created the SECPS also provided for the establishment of the POB.<sup>191</sup> This resolution indicated that the POB, among other things, would "(a) Monitor and evaluate [the regulatory and sanction] activities of the Peer Review and [SECPS] Executive Committees to assure their effectiveness, (b) Determine that the Peer Review Committee is ascertaining that firms are taking appropriate action as a result of peer reviews, (c) Conduct continuing oversight of all other activities of the Section."<sup>192</sup>

Operating under this resolution and related provisions, the POB oversaw the SECPS peer review and quality control inquiry programs and gradually expanded its scope to monitor and comment on other matters that affect public confidence in the integrity of the audit process.<sup>193</sup> When the Commission was

Private Companies Practice Section. The AICPA recently renamed its efforts for firms that provide services to private companies as "Partnering for CPA Practice Success."

<sup>190</sup> Although it is our understanding that "firm on firm" reviews are most prevalent, an SECPS member firm may choose a review team formed by a state CPA society (a committee-appointed review team, known as a CART review), or by an association of CPA firms authorized by the AICPA Peer Review Committee to assist its members by forming review teams to carry out peer reviews (an association review). See AICPA, *Standards for Performing and Reporting on Peer Reviews* at ¶ 15.

<sup>191</sup> AICPA, *Official Releases: Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms*, J. Acct., Nov. 1997, at 113, 114.

<sup>192</sup> See Division for CPA Firms SEC Practice Section, *SECPS Reference Manual*, at SECPS § 100.23.

<sup>193</sup> For example, in 1993 the POB issued a document entitled *In the Public Interest: Issues Confronting the Accounting Profession*, which contained recommendations designed to enhance the reliability of financial statements and improve the performance of auditors. In 1994, in response to issues raised by then-SEC Chief Accountant Walter Schuetz, the POB sponsored a committee that published *Strengthening the Professionalism of the Independent Auditor*, which contained further recommendations in the areas of auditor independence, litigation reform, and the relationship of the accounting profession with various standard-setting and regulatory bodies, including the Commission. More recently, in response to the Commission's concerns about the impact of changes in audit procedures on the efficacy of the audit process, the POB formed the Panel on Audit Effectiveness ("Panel"). The Panel used a "Quasi Peer Review" ("QPR") process to examine the audit processes of large SECPS member firms. The Panel on Audit Effectiveness, *Report and Recommendations*, at 211-17 (Aug. 31, 2000). Each QPR was conducted under the close supervision of the Panel staff, including at least one senior

concerned about the status of accounting firms' quality controls over auditor independence, it asked the POB to oversee a review of the firms' systems and procedures in this area.<sup>194</sup> During discussions about the POB's reviews of the firms' systems of quality controls over auditor independence, the SECPS took the unprecedented step of threatening to halt the funding for the POB's reviews.<sup>195</sup> The SECPS indicated that this step was part of its obligations to its member firms to exercise fiscal responsibility, but it was perceived widely as an indication of the POB's lack of financial independence from the AICPA.<sup>196</sup>

## Appendix B

### The Commission's Endorsement and Oversight of FASB

We have ample authority to set accounting requirements for Commission registrants.<sup>197</sup>

member of the Panel staff, and all of the reviewers had relevant industry experience. *Id.* at 213. The Panel also reviewed the relevant issues and held public hearings. In August 2000, the Panel issued a report containing recommendations for those involved in the audit process and for those who oversee that process. The Panel on Audit Effectiveness, *Report and Recommendations* (Aug. 31, 2000).

<sup>194</sup> The program is in progress and will be completed by the POB staff under the review of an independent party, Donald Kirk. See SEC Press Release No. 2002-40 (Mar. 19, 2002).

<sup>195</sup> Letter from David Brumeloe, Director, SECPS, to Jerry D. Sullivan, Executive Director, POB (May 3, 2000), which states, in part: "The SEC Practice Section (the 'Section') will not approve nor authorize payment for invoices submitted by the Public Oversight Board ('POB') or its representatives that contain charges for the special reviews until such time that the Section and POB determine that such reviews will take place, and accordingly, that the work plan is agreed to by all parties."

<sup>196</sup> See, e.g., *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs* (Mar. 19, 2002) (statement of Charles A. Bowsher, Chairman, Public Oversight Board, Former Comptroller General of the United States).

<sup>197</sup> See, e.g., 15 U.S.C. 77s(a), 78c(b), and 78m(b)(1).

Practically since the Commission's inception, however, we have looked to the accounting profession for leadership in establishing and improving the accounting principles used to prepare financial statements filed with the Commission and relied on by investors.<sup>198</sup> These principles come from a variety of sources, and together form generally accepted accounting principles, or GAAP.<sup>199</sup> Commission rules state that financial statements that do not follow GAAP will be presumed to be misleading, unless the Commission has directed otherwise.<sup>200</sup>

In Accounting Series Release No. 150, which was published on December 20, 1973, the Commission endorsed the establishment of the FASB and stated that standards promulgated by the FASB would be considered to have "substantial authoritative support" and that those contrary to FASB pronouncements would be deemed to have no such support. The Commission, in making that decision, noted that the commitment of resources to the FASB by the private sector was "impressive" and evidenced an intention on the part of the private sector to support the FASB in accomplishing its task of taking "prompt and reasonable actions flowing from research and consideration of varying viewpoints."<sup>201</sup> In that release, the Commission acknowledged and endorsed the FASB as the primary source for GAAP.

The FASB operates under the Commission's oversight. That oversight reflects the fact that our staff, by virtue of its day-to-day activities, often is among the first to identify emerging issues and areas of accounting that need attention. As the staff identifies issues, such as revenue recognition and accounting for business combinations,

the staff refers them to the FASB for guidance. It is our expectation that, in response to such a referral, the FASB will add an item to its agenda to address the issue and will ensure that the item receives the priority requested by the Commission or by our staff.

As the FASB conducts its deliberations, our staff monitors each project to ensure that the process is fair and deliberative, and that any final standard improves financial reporting for investors. The Commission staff, however, does not dictate final standards, but rather allows the private-sector standard setting process to work. Once a FASB project is completed, our staff evaluates the final product taken as a whole. We would expect to take action with respect to a FASB standard if we determine that the standard does not adequately protect the interests of investors.

As companies adopt new FASB standards, our staff monitors implementation,<sup>202</sup> addresses additional questions, and refers unique issues to the FASB's interpretative body, the Emerging Issues Task Force ("EITF"). Through this cycle, many EITF issues have been addressed at the request of the Commission staff because of implementation problems the staff observed in practice.

[FR Doc. 02-16539 Filed 7-3-02; 8:45 am]

BILLING CODE 8010-01-P

<sup>198</sup> See Accounting Series Release Nos. 4 (Apr. 25, 1938) and 150 (Dec. 20, 1973).

<sup>199</sup> For a discussion of the various sources of GAAP and the hierarchy used to determine the most authoritative among conflicting principles or practices, see SAS No. 69 (for periods ending after Mar. 15, 1992), AU § 411.

<sup>200</sup> Rule 4-01(a)(1) of Regulation S-X, 17 CFR 210.4-01(a)(1).

<sup>201</sup> Accounting Series Release No. 150 (Dec. 20, 1973), which is reprinted in the Commission's Codification of Financial Reporting Policies, § 101.

<sup>202</sup> In light of the SEC's unique role, it is critical that the SEC work closely with the FASB. However, no matter how good accounting standards are, there will be instances where answers will not be clear and additional guidance will be needed. In these instances, we have encouraged registrants and their auditors to discuss the issue with the staff prior to the filing of the registrant's financial statements. See Preliminary Note to § 210.2-01; Staff Accounting Bulletin No. 99, *General Comments* (Aug. 13, 1999).