OVERSIGHT OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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OVERSIGHT OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Thursday, June 24, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND,
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:03 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Gillmor, Oxley (ex officio), Capito, Tiberi, Sherman, Inslee, Lucas, Clay, Matheson, Emanuel, Scott and Velazquez. Also present was Representative Maloney.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order. Today, the committee meets for the purpose of reviewing the progress to date of the Public Company Accounting Oversight Board, created in an environment where the professional conduct of the accounting profession had been brought into significant question pursuant to relevant disclosures over the method by which public reporting had failed to meet professional standards.

In the light of that environment, the creation of this board and the assignment of the new responsibilities identified was indeed a significant task for the participants to engage in. Over the course of the past months, the board has engaged in a number of significant steps, including the most recent action on June 18 requiring even higher standards of audit independence. I have found the actions of the board to date to be highly appropriate and very responsive to the express concerns, and certainly should be commended for the manner in which the identified conduct of concern has been addressed.

More importantly, I think the actions taken extend to market participants and market observers a higher level of confidence than ever that the financial statements presented to those who are interested can be more likely relied on as being a true and accurate statement of financial condition of the corporation than ever before.

It was of concern to me that in the course of the committee's work prior to the adoption of Sarbanes-Oxley, we actually had those in management appear before the committee who indicated that the preparation of a financial statement was a mutual endeavor which was the joint property of management and shareholder. The view had developed apparently that managing the statement to meet or beat earnings expectations was somehow in the share-

holder's best interest, as opposed to giving a true and accurate condition of the corporation's actual condition. For these reasons, it was important to have individuals of the highest professional standing in order to bring about the necessary accountability. I am very pleased we have the Chairman of the Board, Mr. William McDonough here this morning to give us his insights into the steps taken and to identify any other areas that the Congress may need to address in light of the work engaged in.

I commend him highly and the board for their great work in the midst of most difficult conditions, and have confidence that their efforts will give many benefits to a prosperous and growing marketplace. That is a goal which I am sure all of us are very pleased to see pursued.

With that, I would recognize Mr. Emanuel who may have an opening statement.

Mr. EMANUEL. Mr. Chairman, thank you for holding this hearing today. I would also like to thank Chairman McDonough for taking the time to be with us, and for your leadership over the last 18 months, and most importantly, for restoring trust and accountability to the accounting profession and the financial markets, given the shaky last 2 1/2 years that have existed in the private sector.

I would also like to thank the Chairman for calling a public roundtable on July 14 for auditors' independence. I wish it could have been July Fourth, which would have been more fitting for auditors' independence, but I do appreciate your doing that. Hopefully, Congress can be invited to participate in some capacity. This issue has been raised both in the public and private sector, dealing with auditors' independence and the issues associated with it. There has also been bipartisan legislation in both the House and Senate. Chairman Oxley and Chairman Baker must be somewhat tired of hearing me gripe about it.

So I do think this is an issue that we need to deal with, and hopefully we can move on the legislation at some point, or if not, for a hearing or a markup, because in the last 6 months we have had an unprecedented suspension of one of the Big Four. It has never been done before, to my knowledge, and maybe you can shed some light on that, and continuing revelations just last week in The Wall Street Journal about one firm which has been offering advice to companies both on the tax side and on the auditing side that I think raises questions.

What this is truly in my view not so much that they are doing something wrong. It is that they are operating in a zone with a flashing yellow light. It is neither a red light nor a green light. The consequences of the lack of that what we would call independence or separation of those functions, how does that spill out and affect the American people? According to the GAO, we face a $311 billion tax gap, much of it due to under-reporting, some of it coming from either the corporate or high-end sector where people are receiving tax advice based on unclear rules.

I would hope that we in this committee can begin to deal with these issues. I would hope that the Board's July 14 roundtable will mark the beginning of not just a public discussion, but a clearer focus on what actions we can take. It is one of the rare moments

here that we have bipartisan agreement and bicameral agreement, and we need to deal with this. The consequences are at the end of the day when you have a $300 billion shortfall of under-reporting or not paying, is that that burden shifts to middle-class, working-class families. And nobody then believes the system is fair or that everybody is playing by the same set of rules. And the system, and we represent that system, loses confidence by the American people.

So I look forward to your hearing today, asking questions on the subject, and your leadership on this very one particular point. Not only your last 18 months, but I hope the next 18 months are as fruitful for the private sector as the first 18 months.

With that, I yield back.

Chairman BAKER. I thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Less than 1 year ago, this committee held a hearing entitled Accounting Under Sarbanes-Oxley: Are Financial Statements More Reliable? That was the first time that our distinguished witness, Chairman McDonough, appeared before Congress as Chairman of the Public Company Accounting Oversight Board.

I am pleased to report that, due in no small part to his exemplary leadership and that of the other board members, the answer to the question we posed 9 months ago appears to be a resounding "yes."

While the problems that led to the passage of the Sarbanes-Oxley Act nearly 2 years ago have by no means disappeared, the Act's wide-ranging corporate reforms and the effective actions of the PCAOB have helped to restore the faith of America's investors.

In his brief tenure, Chairman McDonough has transformed the board, the centerpiece of Sarbanes-Oxley, into a rigorous, effective and highly respected overseer of public accounting firms. The board has spread a little fear, and Chairman McDonough has hit the proper tough-but-fair tone, in my estimation. I have been reading your speeches. He has listened to practical implementation problems and has worked to ease them, provided it does not interfere with Sarbanes-Oxley or the PCAOB's mission. The PCAOB has been a vast improvement in accounting industry regulation.

We will learn today about the inspection process that the board began during its startup year of 2003 and the auditing and professional practice standards that the board has both adopted and proposed. I would particularly like to commend Chairman McDonough for his accommodations on foreign firm inspections.

I am pleased that the Securities and Exchange Commission recently approved the board's final internal control standard as required by Section 404 of the Act. The internal control requirement of the Act has been the focus of some criticism from sectors of the business community. My view is that these costs, although never pleasant, are offset by great benefits.

In implementing the protections of Section 404 and, indeed, all of the Sarbanes-Oxley Act, it is essential that regulators seek to minimize the cost of compliance as much as possible, consistent with the Act's goals. The board has done exactly that, and we will learn more about that today. At the same time, we must keep the appropriate perspective. According to one report, there were 323

companies that restated their results last year. In 58 of those instances, the outgoing accounting firm reported problems related to internal control. Clearly, the need for strong internal control has not diminished.

Equally important, I am pleased by reports of the positive effects of the internal controls requirements on public companies' business. General Electric's finance chief recently stated, "We have seen value in the section 404 work. It helps build investors' trust and helps give them more confidence. We have gotten positive benefits from it." This is precisely the purpose of this requirement.

There is much more work to be done, but I remain confident that Chairman McDonough and his colleagues will continue to ensure that financial statements are more reliable.

Again, Mr. Chairman, welcome you back to the committee. It is good to see you again. We look forward to your testimony.

I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 30 in the appendix.]

Chairman BAKER. I thank the Chairman.

Are there further opening statements? Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

I, too, want to welcome you, Chairman McDonough, to our hearing. I want to thank Chairman Baker and Ranking Member Kanjorski for holding this hearing today on the progress of the Public Company Accounting Oversight Board.

This hearing is particularly timely, given that the board issued its first annual report last week. The Sarbanes-Oxley Act of 2002 was enacted to end self-regulation for the accounting profession. Historically, auditors were regulated by the American Institute of Certified Public Accountants. The board was created to serve as the regulator for auditors of public companies and set higher corporate standards for auditing.

I am very much concerned about the issue of the inspections and I am very delighted and pleased to learn that the inspections, according to you, Mr. McDonough, will go beyond the traditional peer review and technical compliance, to look at firm culture and practices to ensure that compliance is encouraged. This is very, very important. You went on to further note that these limited inspections disclosed significant audit and accounting issues, and the need for enhanced standards, and you emphasized the importance of the information gained through individuals and auditing engagements.

The board's new standard of guidelines for accountants was approved by the Securities and Exchange Commission on June 18. There have been some complaints by public companies about the costs of complying with these new standards and the clarity of guidance on complying with the new rules. While some resistance is expected to new regulations, I would like to better understand the depth of these concerns, especially on the compliance costs to small firms.

I look forward to your testimony today, Chairman McDonough, to detail the progress from the board.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

First, I want to thank Chairman Baker for holding this oversight hearing on the PCAOB. The committee's recent series of oversight hearings has illuminated many important issues with our nation's capital markets regulators, many of which would have not been addressed had we not undertaken these very hearings. So I am thankful that this committee has taken its oversight responsibilities seriously.

I believe that the success of our capital markets is dependent on accurate and truthful information. Without such information, investors will not be able to make informed decisions. This is why Sarbanes-Oxley is so important, because it provides investors with greater confidence in the information they rely on.

The investor population is more diverse today than ever, from union workers investing through pension plans to professionals investing through 401(k)s to retirees investing through IRAs. They all have money invested in public companies. For this new class of investors, who typically rely on professionals to guide their investment decisions, increased scrutiny of corporate audits is essential. It provides these investors with some additional comfort that there is someone watching the shop on their behalf.

While Sarbanes-Oxley is in the process of bolstering audit requirements and providing increased scrutiny of corporate audits, I would like to raise one specific issue here today: the potential need for an alternative audit standard for smaller non-public companies. Although Sarbanes-Oxley was intended for public companies, it appears that many smaller, non-public companies may be adopting PCAOB standards. Often, the adoption of these enhanced standards is voluntary, but I have a concern that the adoption of the PCAOB standard may become a quasi-requirement for many non-public companies.

In many of these cases, the adoption of the standards is not driven by a desire to protect the investing public, but rather to satisfy other private interests. In addition, the cost of obtaining a full PCAOB quality audit is quite significant, requiring both a substantial startup investment as well as considerable ongoing costs. In pursuing this one-size-fits-all approach, I have great concerns that this will create an excessive burden for many smaller non-public companies, while at the same time doing little to benefit the investing public.

These companies represent about half of the U.S. companies and are a major driver of economic growth in our communities. By unnecessarily diverting significant resources to PCAOB compliance, these smaller companies will be unable to expand their operations or hire new employees. As a result, we may be unnecessarily hindering growth at a time when we need more high-quality new jobs.

I hope to learn more about this issue today and I look forward to hearing Chairman McDonough's perspective on this issue.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Mr. Lucas, did you have a statement this morning?

Mr. LUCAS OF OKLAHOMA. I am looking forward to the Chairman's testimony.

Chairman BAKER. Great statement.

If there are no further opening statements, at this time I would like to recognize Mr. William J. McDonough, chairman of the Public Company Accounting Oversight Board. Welcome sir. Please proceed as you choose.

STATEMENT OF WILLIAM J. MCDONOUGH, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. MCDONOUGH. Thank you.

Chairman Baker, Chairman Oxley, members of the subcommittee, I am pleased to appear before you today, and I want to thank the members of the subcommittee and the entire House Financial Services Committee for your strong bipartisan support of the Public Company Accounting Oversight Board. We benefit greatly from your wisdom and encouragement.

With the landmark Sarbanes-Oxley Act of 2002, Congress took a giant step toward restoring investor confidence in financial reporting and in the auditing of public companies. No one should doubt that it is the faith of investors that fuels the growth and competitiveness of our economy, not the freedom of corporate managers from public regulation and oversight. The Sarbanes-Oxley Act sets out the blueprint for rebuilding investors' faith.

Over the last 18 months, we have turned the Sarbanes-Oxley blueprint into an operating organization. Today, the PCAOB is well on its way to maintaining a continuous program of auditor oversight, to quote from the statute, "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." Registration of public accounting firms that audit public companies is the foundation of the board's authority. Since October 22, 2003, it has been illegal for any U.S. public accounting firm to prepare, issue or play a substantial role in an audit report on the financial statements of a U.S. public company unless the firm is registered with the board. As of July 19, the same restriction will apply to non-U.S. firms. As of yesterday, we have registered 1,003 U.S. and non-U.S. public accounting firms that audit or may wish to audit U.S. public companies, and we continue to receive registration applications.

Once a firm is registered, it is subject to board inspections. The Act and the board's rules require annual inspections of the firms that audit more than 100 public companies. Smaller firms that have at least one public company client will be inspected every three years. Although regular inspections began this year, we launched limited procedure inspections of the Big Four firms in 2003. We recently made our draft reports on those limited procedures available to the Big Four firms.

Even with limited inspections, we learned a great deal about quality control in the largest firms. In numerous interviews, we heard audit partners and staff express their perceptions of a renewed focus on audit quality. We have seen some evidence of this renewed focus in firm policies generally, and in internal firm communications about those policies. Even so, we alerted the firms to quality control concerns and we will continue to look hard at whether the firms' conduct mirrors their words.

We also learned that there is tremendous wisdom and value in the Act's requirement that we review selected audit engagements. Although we reviewed only a small number of engagements in 2003, we identified significant audit and accounting issues. As we examine more engagements in the future, we expect the prospect of scrutiny to alter the relative risks and rewards to individual engagement partners who might otherwise consider short-cutting audit steps or bending to pressures to please clients.

Our inspections also provide valuable information about the need for enhanced standards. In reviewing audit engagements in 2003, we became concerned that auditors may place insufficient emphasis on the importance of thorough documentation of audit work. The Act expressly required us to adopt an auditing standard on documentation and we were able to use what we had learned about existing documentation practices to develop the new standard.

Situations will inevitably arise in which standard setting and inspections are inadequate tools for addressing auditing problems. When we find serious violations of PCAOB standards or the securities laws, we will use our authority under the act to investigate and, as appropriate, to seek disciplinary sanctions against the firms and auditors under our jurisdiction. Those sanctions include monetary penalties and even revoking a firm's registration, thus preventing it from auditing public companies.

We will continue to push forward step-by-step toward the world envisioned in the Act. It is a world in which public accounting firms are strong, reliable businesses that compete based on virtue. It is a world in which the investing public has enough confidence in the fairness of our capital markets and in the auditors who stand in their place, to invest their and their children's futures in those markets. And it is a world in which U.S. companies have access to rich capital markets funded by those investors to grow new businesses, to develop new products, and to hire new employees to design and produce those products.

Mr. Chairman, thank you for the opportunity to describe our progress towards this goal. I will be happy to answer any questions.

[The prepared statement of William J. McDonough can be found on page 34 in the appendix.]

Chairman BAKER. Thank you, sir. Once again, I express my appreciation for what appears to be a very well done job over the past 18 months.

I would be interested in your view with regard to the effect of the new standards, the accountability that is now required with regard to a corporation's ability to attract capital or investors. Do you see any measurable improvement, any measurable concern as a result of the implementation of the standards? There was the view at the outset by some that this would simply raise the cost to the corporations without any measurable benefit. Perhaps a better way to say it, from a cost-benefit analysis, forgetting for the moment the concerns raised by inappropriate conduct, in real business dollars has this been a net gain for corporate America or is it a net expense?

Mr. MCDONOUGH. I would say thus far it is a net gain. However, we did try to put into the internal control standard, our auditing

standard number two, as much cost-benefit thinking as we possibly could. I must admit that we stretched the statute as much as we thought the statute could be stretched in order to do that.

We think that is particularly important because of the concerns that Congresswoman Velazquez mentioned earlier, and that is the effect on small-and medium-size companies. If you look at a large company, as Chairman Oxley mentioned, the excellent remark from General Electric, they invested I think they said about $30 million, which is not a great deal of money for General Electric, in 404 implementation and they thought it was money well-spent. In the case of large firms, first of all, they should have had good internal control standards, and if they did not and they have new expense to put in the internal control standards, what it tells us is they should have done it in the past. I do not have much sympathy for the large firms in this regard.

There is a requirement, of course, that they document the internal controls. I always though, in my days of being a chief financial officer, if you have internal controls, you ought to document them in any regard, but in some cases they actually had the controls, but had not documented them very well. That is a new expense. There is no question that the attestation by the auditor of the adequacy of internal controls is a new expense, one that I think is justified.

When you get to small-and medium-size companies, I think what has to be used and what we try to push very hard is that both the issuers themselves and private companies, for that matter, have to use good judgment. I think one of the greatest things in God's work in creating human beings is the giving of judgment. A small-or medium-size company simply does not need the bells and whistles on internal controls that General Electric needs. It would be very ill-advised and a terrible waste of money for them to have all those bells and whistles. So we expect them to look at the nature of their business, how complicated it is, how difficult are the internal controls, to make sure that they have the level of internal control that they really need.

Then we also expect the audit firms to use their judgment to say, given the reality of this firm, do the internal controls set up by management actually meet the test of good judgment? If the answer to that is yes, then in our inspections I will expect our inspectors to say, if the firm used good judgment, if the company used good judgment, whether or not our inspector would have done it exactly that way is not important.

The important thing is, did the company and the audit firm use good judgment? If the answer to that is yes, we should bless it, because we do not want to have unnecessary expense. I believe vehemently and have for years, small-and medium-size companies are the guts of the American economy. They are the net creators of new jobs. We do not want, and especially I do not want, because of my long record on this issue, to have anything that PCAOB does step in the way of growth of the American economy.

Chairman BAKER. Thank you. I have time just to get one more question in here.

I note that you have made an observation with regard to executive compensation, and reasonableness. I recently had a document published by some organization that not single-line businesses, but

complex, sophisticated financial organizations, that the average salary, not benefits, was $12 million a year and the average value of stock held in the institution which they managed was $800 million. I do not want to call it disturbing, but I was surprised by the numbers. These are averages. These are not the extremes.

Is there a better way to have disclosure of compensation packages so shareholders can make the appropriate judgments? I am not second-guessing anyone. I am certain there are individuals worth those dollars. I just think that if you are in an environment where the company may be losing money, that might be one area where one would want to focus some attention. Do you have views on that?

Mr. McDONOUGH. Mr. Chairman, I have probably reached the point of being notorious for having views on the subject of executive compensation. The first time I spoke on the matter was in the sanctuary of Trinity Church at the foot of Wall Street on the first anniversary of 9-11, and have been speaking about it ever since. Why do I think it is important? I think it is important because the nature of this greatest of all countries is the belief that we are all in it together; that if you were born in humble circumstances, I was, that you have full opportunity to participate in the American Dream.

I think that everybody probably thinks from your district, I hope that every kid in the district thinks that he could be your successor some day. I think that a lot of people think they can be President of the United States. But I am really worried about whether people think that they can get to the top rungs of business because of this very high pay, as to whether it is becoming a closed club. I think the nature of the American society works much better in the old days; in 1980, the average Fortune 500 CEO made 40 times more than the average person who worked for him or her. That sounds pretty reasonable. Now, by 2000, it was between 400 and 500 times, and last year I believe that same study said it was about 530 times.

There is no economic theory on God's planet that can justify that. It was a breakthrough of greed in the 1990s, which is understandable because it looked as if we had the great economic miracle. I do not think that there is a way that, and I think your remarks suggested it, that we can figure out how to legislate a control over it or how the SEC or anybody else can figure out how to do it.

I think what it comes down to is the common sense, never mind good judgment, of the people running these major companies. As I have suggested publicly, if the CEOs do not have enough sense, well then their boards of directors should decide they probably need a new CEO. Somebody with such lousy judgment probably should be replaced anyway.

So I do think that on a firm-by-firm basis, the private sector has to, and I spend a lot of time trying to encourage them to take over the responsibility for doing the right thing. Disclosure I think is very important, but if what is being disclosed with all the detail that one can imagine is excessive and inappropriate greed, well, it will make it more obvious. But I think mainly what we need to do is to correct a problem that I think is really a difficulty for our society that simply must be overcome.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman.

Chairman McDonough, some Fortune 500 companies have complained about the costs associated with Sarbanes-Oxley. Could you compare the compliance costs associated with Sarbanes-Oxley to some of the Fortune 500 compensation packages for CEOs?

Mr. MCDONOUGH. I suppose an easy remark, Congressman Emanuel, would be that in most cases the cost of implementation of Sarbanes-Oxley is less than the pay to the CEO.

That is an interesting comparison. I think, as I mentioned earlier, in the case of large companies, it is very clear that the Congress of the United States, 97 to nothing in the Senate, three negative votes in the House of Representatives, decided that the American private sector had to be run in a somewhat different way, a bill which I applauded at the time and now am spending a lot of my life trying to implement.

I think that the money in large companies that is spent for a reasonable implementation of the Sarbanes-Oxley requirements, especially the internal controls, is fully and unquestionably justified. I do have the belief, as I mentioned earlier, when you get to small- and medium-size companies, we ought to size the thing properly.

Mr. EMANUEL. Let me go back to the issue of auditor independence. I do believe what we have is not a right and wrong. We have a flashing yellow light and people are unsure of the terrain, the people being those in the financial services industry and financial services advice industry to boards and to management, top management.

Since four major accounting firms basically audit close to 80 percent of the public companies, if we do not act here in Congress and set some clear guidelines, which is why I think we do need to act, how do those on the regulatory side deal with the fact that four companies monitor, audit and offer financial advice to nearly 80 percent of the public companies, and without enacting measures or penalizing wrongdoers in ways that would harm the financial markets?

Mr. MCDONOUGH. Congressman, I think we have to distinguish between some of the things that we are reading about in the papers about the large firms, which are things that they did in the past I spent a lot of time talking with the leadership of the four firms, and if there are any people in this world who want to get that behind them, it is they.

Mr. EMANUEL. I would agree with that.

Mr. MCDONOUGH. Let's say now looking forward, what our responsibility is . As you know, it is limited to the activities of the accounting firms in dealing with their audit clients. I think the area in which you are particularly interested is the area of tax, which is what our July 14 roundtable is about is auditor independence as it refers to tax advice. What I have been telling the leadership of the Big Four is that what they have to do is to restore the faith of the American people in the accounting profession as a profession and in their firms in particular. The American people do not make a whit of distinction between the audit practice of the

firms and the rest of the firm. For the American people, it is one thing, one firm.

Therefore, I have been very strongly and very vehemently suggesting to them that even though I do not have the legal capability to tell them what they can do for their non-audit clients, if they are doing anything that is sort of towards the creative end of just where the IRS might let somebody get away with it, it is an extraordinarily ill-advised thing for them to be doing because they will destroy any possibility of restoring the faith of the American people. So I think the good judgment of the people running the firms, if they swing into gear and carry out that which I think they should in their own best interest, then I would have to leave it up to you and the Congress as to whether you need legislation or not.

Mr. EMANUEL. Let me follow up on that last point. Is it your view then, that we should be patient here, and see how the market handles this, both from a regulatory and legislative perspective? Or should we begin to do something from the legislative side that sets clearer rules of the road?

Mr. MCDONOUGH. That is a question that comes very close to one's personal philosophy, so I will have to share mine with you. I think that the Congress and those of us who are created by the Congress have the responsibility to serve the best interests of the American people and that comes first. We have loaded the private sector with an awful lot of new things to do, like internal controls. We have loaded on the accounting firms a new era of oversight, of very penetrating inspections by the PCAOB people.

That would lead me to believe as a generalization that it would be wise to let see how it is working out, and especially since I am seeing in the leadership of the private sector generally, except on the compensation issue, and in the leadership of the accounting profession, a view that they really did get the message of Sarbanes-Oxley.

If that is true, one might, at least my philosophy would be to let's give it some time and see if it works. If it does not, it is rather what we say to the accounting profession, you will either restore the faith of the American people voluntarily or we will make you do it. It is going to work a lot better if it is done voluntarily.

Chairman BAKER. I thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

I want to explore a little bit with you, first of all, I totally concur with your statement about stretching the statute to accommodate as best we can the small-and medium-size company. That clearly is an issue. It is one that comes up quite a bit in my conversations with CEOs and CFOs. I applaud your foresight and ability to do that within the bounds of the statute. I think it is critically important.

It is also true that in the cost area for Section 404 that we look at some interesting numbers. The average salary of a Fortune 500 CEO in 2004 was $6.6 million. Richard Scrushy, the former CEO of HealthSouth, his bonus in 1 year alone was more than $10 million, about 10 times what it would cost for a company of that size to comply with the act. So I think when we put it into that perspective, clearly we did some things right. I want to applaud you and

your colleagues there on the board for recognizing that. I think it is clearly important.

Also, is it not true that once the internal controls are set up, that is what incurs the most expense in my view of things. That is, once you have to set up the infrastructure essentially for compliance, which assuming it is done correctly and approved by you and the SEC, will be ongoing. So isn't it true, Mr. Chairman, that a lot of those costs are a one-shot cost?

Mr. MCDONOUGH. Mr. Chairman, setting up the controls is a one-time cost. I think, however, that the issuers themselves, the companies themselves will have to be very careful to keep an eye on whether their internal controls, which may have been perfectly wonderful in the year 2004. Perhaps with new information technology or whatever comes along, you might want to modernize them in 2007.

When I was Chief Executive Officer of the Federal Reserve Bank of New York, we put in the COSO implementation of internal controls. After about 3 years, I found that my people were getting a little relaxed, so I upped the ante and made the internal controls tougher. I think a CEO might want to do that. The auditor also will have to take a look and make sure that the internal controls have not changed, the application of them. So although the first year expense will be considerably higher, the expense on an ongoing basis will be higher than it was in 2003.

Mr. OXLEY. I accept that. I understand that. Let me also commend you on using what lawyers would call the "reasonable man test," because ultimately that really is critically important that we allow some judgment here, and that we do not get ourselves so boxed in on compliance that we lose sight of the goals that we are trying to accomplish. So I applaud you for that attitude.

There will be some people in some quarters, as you know, that will be more than willing to second-guess and to say that you need even more strict controls and that you have to go literally by the letter. Obviously, it just does not work under those conditions. So I really thank you for your judgment in that area.

One of the things that I think concerns me and others, with the demise of Arthur Anderson, we are really down to the final four in terms of a national accounting industry. Does that give you some pause in terms of the lack, or at least apparent lack of competition out there? Do you see anything in the future that would maybe provide that some of these companies actually, and it has been suggested in some quarters, that they split into different parts, or perhaps the large regional accounting firms kind of stepping up and becoming national firms? What are your views on that?

Mr. MCDONOUGH. Mr. Chairman, I think that it is the single most difficult issue in public policy in this area. The GAO was required by Sarbanes-Oxley to do a study of concentration in the accounting profession. It came to the conclusion, to just slightly oversimplify, that we have four firms; that the idea of growing a number five of anything like comparable size out of one of the regional firms would look pretty tough to do. Therefore, one is left with the notion of what do you do about the Big Four.

One of the things that came to my mind immediately is you may remember that I was probably the most vocal person at the Federal

Reserve on the notion that there was no such thing as a bank too big to fail, largely because I think as soon as you say a bank is too big to fail, you have de facto nationalized it. We can also not say that it is absolutely essential to the American people that each of the Big Four survive if, heaven knows I hope it does not happen, if one of the Big Four should so mismanage itself that it does not deserve to survive.

Now, my conversations with the leadership of the Big Four make me think that is a very remote likelihood, but we have to make sure, and I have made very clear to the leadership of the Big Four, both individually and collectively, that their future depends on them, not the PCAOB. What I am not sure anybody can figure out is, if the Big Four either voluntarily or somebody pushing them, divided into the Big X, would the Big X be on average better and therefore the public interest is served? Or on average less good and therefore the public interest is disserved, if there is such a word? I do not know the answer to that question and I am not sure anybody does. It is an immensely important question and I think we have to keep figuring out what the real answer to it is, but as of now I do not know that anybody knows the answer to that.

Mr. OXLEY. Thank you. If I could just take 1 more minute, Mr. Chairman, I wanted to just weigh into this executive compensation issue, only to raise the issue. I do not think anyone is proposing that government try to manipulate or to change the current system, is that correct? I mean, in a direct way, we are not going to pass a law to deal with executive compensation.

Mr. MCDONOUGH. I must admit, Mr. Chairman, that I, in my sermons to the CEO corps, hold out that if they do not do it voluntarily and the American people continue to be very upset about it, that legislation would have to be considered. I must admit that I am stepping into the province of the Congress of the United States when I do that, but I think there has to be at least hanging out the possibility that if they do not do it voluntarily, the Congress might try to figure out a way to do it for them.

Mr. OXLEY. What is your view that with the changes taking place in the boardroom with more emphasis on independent directors and the like, won't that in and of itself have a mitigating affect on executive compensation? Won't that at least be partly solved in the marketplace?

Mr. MCDONOUGH. It should be. There is no doubt in my mind that independent directors, members of compensation committees, should take on the responsibility of getting executive compensation back to a more rational level and one which would be more acceptable to the people of the United States. I hope very much that will happen. I think you and I both know the kinds of people who serve on those compensation committees. They are people of good character and I sincerely hope that they will carry out their responsibilities.

Mr. OXLEY. I am somewhat encouraged by that. You are even starting to see that in major league sports today, a kind of a leavening of that. I would hope at some point we could get to a point where some banjo-hitting utility infielder does not necessarily make $2.5 million a year, but I digress.

[Laughter.]

I do think it is an issue worth going after. Mr. Chairman, I would ask unanimous consent, we had a study done by the committee on the compliance costs for Section 404, based on revenue of various corporations. I think it really is a quite extraordinary study, where it says the average salary of a Fortune 500 CEO in 2004 was $6.6 million and the average cost of compliance for domestic companies is $1.92 million. So it is a very interesting statistic and I would ask unanimous consent that the study be made part of the record.

Chairman BAKER. Certainly, without objection.

[The following information can be found on page 82 in the appendix.]

Mr. OXLEY. Again, Mr. Chairman, thank you for your appearance again. It is always good to have you here, and most enlightening testimony.

I yield back.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Chairman McDonough, it seems to me that one of the most effective tools that you have at restoring investor confidence is within the periodic inspections. Could you share with us how that is working, particularly what success it has had in detecting fraud, and making sure that there is compliance in terms of professional auditing standards? That is the first part of my question.

The second one is, is the board making adequate progress in terms of addressing the concerns of foreign regulators in terms of overlapping areas of compliance?

Mr. MCDONOUGH. I think we are making good progress on both of them. The nature of our inspection is we go into a firm and the main thing is that we start by looking at what we call the tone at the top. Do the people who run the institution understand what their requirements are under the Sarbanes-Oxley Act and the fact that the American people, I always remind them it is the American people as represented by the Congress, have decided that their profession needed an outside overseer in the PCAOB.

We want to make sure that they understand that audit is their most important product. We get into their relative compensation of partners. We want to see that the good audit partners get well rewarded and not, for example, that the people who are very good at bringing in new business get most of the additional compensation. We also talk with everybody involved in the firm, especially down to the kids that they hired in the last few years, because we have to assume that the people running the firm would really have to be pretty dimwitted if they did not tell us what we want to hear and what the law says. But that does not do a whole lot of good unless they get that message really understood by all the people who work for them. So we look into that.

Then we look into their individual engagements. The amount that we looked into in the case we did, just the Big Four, as you know, and we looked at 16 engagements for each of the firms. That is a very, very small sample and one has to be careful that you do not draw too many conclusions from that small a sample, but we think we have some pretty good ideas.

The inspections that we are doing this year will be much more detailed. In the case of the Big Four, we will be looking at about 5 percent of their engagements, and the biggest firm has about 3,600 engagements. So 5 percent is a pretty important statistical sample. In the case of the next lot of firms, we will be looking at about 15 percent. We look at a combination of what looks like high-risk clients, very complicated companies, for example, and then we do a statistical sample so we pick up the rest, a random sample.

When we get to the smaller accounting firms, as we get in there, we will have to figure out, we are doing those inspections now, and some of them will probably think, we better look at pretty much all of their engagements because we are not really sure how good they are. On the other hand, with others that really seem to be very, very well organized and really very good, and we look at one or two engagements and say, wow, they are terrific, well then it would not be wise to spend their time and money and our time and the public's money to do it further. I think that this will be a very effective tool to restore confidence.

On the second part of your question——

Mr. SCOTT. Before you leave that part about the periodic inspections, are there notices given to the firms? Is there leeway time or is it a surprise inspection?

Mr. MCDONOUGH. We give them a very small amount of notice because it is better if you see them as they really are.

Mr. SCOTT. When you say small amount of notice, how long?

Mr. MCDONOUGH. The typical amount would be just a couple of days, so they cannot pretty themselves up. They know we are coming so, for example, they know that the top of the shop should be there, but we quite deliberately want a certain level of surprise in the inspections.

Mr. SCOTT. And you have given them during this last year, is that right? It has been a year?

Mr. MCDONOUGH. Last year, we did a limited inspection, as we call it, of the Big Four. They, by the way, volunteered to do that because we began those limited inspections in June and legally we did not have the right to inspect them until October. By the way, I thought that was a good sign of good will on their part.

This year, we have a legal requirement to inspect each year eight firms, because there are eight firms in the United States and one in Canada which have more than 100 public company clients, issuers, so we have to inspect them annually. All the rest, which have one client or one issuer or more, we have to inspect every three years. That, by the way, is going to be a real chore this year because we are still a startup and we are still assembling our staff. Whether I will be able to get to one-third of the rest of them this year or whether we will have an extra burden in the second and third year, unfortunately it is likely we will have a bigger burden in years two and three.

Mr. SCOTT. I want to get to my second question, too, so bear in mind my time, Mr. Chairman, but what has been the finding? What has been the result? In other words, you have given these periodic inspections to the top four. They have been limited inspections. Any surprises? What have been the findings?

Mr. McDONOUGH. We have made available to the four firms our reports. They have 30 days from when they got them, which was in the last day or two, for them to respond. However, the general feeling that we have, which is what I think you are looking for, is they are in fact paying attention to doing audits better, but they did not really have a whole lot of time to improve their performance before we were in there looking at them.

Therefore, we found some situations where their issuing clients and the engagements we looked at did not appear to follow GAAP. That then becomes the province of the SEC, because SEC is in charge of accounting policy, not the PCAOB, but the auditor should bring it to the attention of the issuer, which then deals with the SEC if there is a restatement involved.

In terms of overall really tough application of quality, there is room for improvement. One thing that I am very certain of is the inspections are a very good idea. I thought so before we did these and I am even more sure now.

Mr. SCOTT. I think so, too. I think they are the most effective way to get confidence.

And if you could, my other question concerning the foreign regulators and their concerns over overlapping.

Mr. McDONOUGH. There were enormous concerns and a great deal of noise coming from quite a number of foreign countries on the alleged extraterritoriality of Sarbanes-Oxley. The extraterritoriality comes for a very good reason. Foreign firms and foreign companies issue securities in the United States and the Congress wants to protect the American people and other investors in those securities.

What we have been able to do is essentially the whole thing has been calmed down. We have had very good discussions with the Canadians. About one-third of foreign issuers are Canadian. We have had excellent discussions with the European Community. I made three trips to Brussels. Fortunately in my previous life at the Fed, I had worked with exactly the same people. We all figured out that they are trying to protect investors. We are trying to protect investors. Why don't we just do this together?

So the way we are working it out, we have what we call a sliding scale. If an audit overseer in another country has, it kind of looks like the PCAOB, essentially that it be free of the profession both organizationally and financially, and therefore can oversee it as a true third party. In that case, we would ask that our inspection be actually conducted by the audit overseer in that country.

So let's say we are talking about the United Kingdom, we would ask the United Kingdom overseer to do our inspection. We would send a couple of people over to make sure that they understood how we do things. Conversely, if there is an American company which sells securities in the London market and the UK would decide that they would like to do an inspection, we assume that the UK audit overseer would ask us to do their inspection for them.

So it is 100 percent reciprocity. If we have a country in which the audit overseer either does not exist or would not have full confidence, then we will have to do much, much more of the inspection ourselves.

Chairman BAKER. Mr. Scott, your time has expired.

Mr. SCOTT. Thank you very much, Mr. McDonough, for your fine answers, sir.

Chairman BAKER. Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Chairman, while Sarbanes-Oxley was intended to apply to public companies, it is clear, and we discussed that already, that many smaller non-public companies are adopting the new PCAOB audit standards. For instance, not-for-profits with outstanding municipal debt, private companies with a large private shareholder base, or private companies seeking venture capital are finding that they might have to adopt in full or in part increased audit and internal control standards.

What is your perspective on the adoption of PCAOB standards by non-public companies?

Mr. MCDONOUGH. I think, Congresswoman, that there is much, much to be achieved if we can have essentially single audit standards. As a legal matter, we have the authority to set the audit standards for public companies. So there is a question of, well, what should private companies do? Should they have a separate set of standards? There is a certain amount of discussion about that, and I fear that there may be a certain amount of desire in certain parts of the accounting profession to keep some areas of responsibility, also known as turf, that they used to have.

David Walker, who is a wonderful colleague, the head of the GAO, as you know, and I invited the head of the Accounting Standards Board to work with us in a forum so that as much as possible we could get the yellow book standards for the government, the public standards which are set by the PCAOB, and standards for private companies to be as close as possible.

Why would you want the public company audit standards to set the way? The reason is that there are some public companies that actually go private, but not very many. Lots of private companies go public and you would not want an obstacle of vastly different auditing standards to be in the way.

What I think is helpful, because I very much share the concern behind your question and your opening comment, is we have to ask everybody involved, including in the companies and in the audit firms, would you please use your heads? Figure out how much you really need in the way of what would be required for a huge company for the auditing, the methodology, the bookkeeping of a private company depending on its size. A large private company, as you suggested, with lots of private participants in its ownership probably needs something that looks very much like a public company.

On the other hand, a rather small public company probably needs something in the real world that would look much more like a private company. So in trying to insert what you could either call cost-benefit or, what I say, really use judgment, we are really trying to make it as possible as I can conceivably make it for smaller public companies and for small-and medium-size private companies to participate in this greater insight and credibility of financial statements without it being a cost which is just not, in some cases they just cannot bear the cost. They do not make enough money to do it.

Ms. VELAZQUEZ. At this point, you do not think that we need to develop, or that there is a need for an alternative standard that would apply only for nonprofit companies?

Mr. MCDONOUGH. I do not think that there is such a standard, but we do not have the authority to do anything except state an opinion on that.

Ms. VELAZQUEZ. Okay. The PCAOB only annually examines firms that audit 100 or more public companies. For all others, it examines on a 3-year cycle. Do you believe that those firms receiving an annual inspection will be perceived by the marketplace to be the gold standard, and thus lead to further concentration in the public accounting industry?

Mr. MCDONOUGH. I do not think it should. Is that a very good question? You bet. On the other hand, the Big Four really deal with big companies. The next four tend to deal with the remainder of the ones in the United States that we inspect annually. They tend to specialize on essentially medium-size companies. Since they are to a degree regional, they are medium-size companies in their own area, and they find that that is the best market niche for them.

I think if I were a small-or medium-size company and I had an accounting firm that as on the 3-year cycle and I had confidence in that accounting firm, I would not spend a nano-second thinking about changing to a big firm just because it got inspected annually. I just do not think there would be any need to do that.

Ms. VELAZQUEZ. I know that the PCAOB has thought long and hard about how the results of examinations are going to be made available. Obviously, providing both investor and corporate clients with information concerning the degree of the reliability of audit work is relevant to a whole host of decisions. Could you tell me what information the public and corporate clients will receive and in what form?

Mr. MCDONOUGH. In the area of quality control, the statute makes it very clear that if we find things that need improvement, that is, criticisms in the area of quality control, the firm has a full 12 months from the date of the report to fix those matters. If they do so within 12 months, it remains confidential forever. There were people who kind of wondered about that. My own view is that that gives us a very effective tool to say, fix it within 12 months or it goes public and you probably do not want it to go public. It is a wonderful discipline. It is like telling your kid you have to pass school this year.

More broadly, we do believe that we have an obligation to the public to have as much to say in the examination reports as the statute permits. So rather than say we will put out a statement that says we examined firm X, period, which would be of no earthly interest to the public or no value to the public, we are interpreting the statute as one that says, very definitely in the quality control area, confidential. If we have a discussion of something that had to do with the experience, say, in accounting or auditing matters, of a specific issuer, we will discuss the concept, but not mention who the issuer was.

So it is a very delicate balancing act between our keeping the confidentiality requirements of the statute and saying enough so

the American people can judge how much progress is being made by the profession in general and the firm in particular.

Ms. VELAZQUEZ. Do you intend to create a rating system?

Mr. MCDONOUGH. No, we will not have a rating system. I think that is too simplistic and too given to people interpreting it, taking it too seriously.

Ms. VELAZQUEZ. Thank you.

Chairman BAKER. Thank you, Ms. Velazquez.

Mr. Sherman.

Mr. SHERMAN. Thank you.

We have been shaken, of course, by the failures, the two kinds of failures, if I can categorize them. One is exemplified by Enron, where the auditor pretended that what he saw was okay, and was being properly described in what turned out to be phony financial statements; and the WorldCom example where they pretended not to see the basic facts. There is no accounting principle where you can take a couple of billion bucks worth of operating expenses and capitalize them. It is not a matter of twisting a gap; it is more a matter of covering your eyes.

With that in mind, one of the things I have been talking about before my colleagues, perhaps more often than they would like to hear it, is the need to look at the balance of power within the accounting firm, between on the one hand the client partner, who golfs with Ken Lay; who becomes useless to Arthur Anderson if Ken Lay takes his business elsewhere, if your job is to service a client that produces $50 million in revenue and that client goes elsewhere.

And then the other side of that balance is the review department. At Arthur Anderson, perhaps unique among accounting firms, and this may oversimplify, it had a 100 percent balance of power in favor of the client partner. The review department was on a don't ask/don't tell basis. If the client partner does not feel he needs any advice, the review partner does not even see the questions.

I have urged my colleagues here to provide by statute, it may in the view of many in Congress be more appropriate for your board to do this, but what are you doing to make sure that that Arthur Anderson structure is never allowed and that people whose job it is to assure quality control, people who never golf with any one client because they are involved in 100 audits a year as reviewers, have the balance of power in their direction, and that if the reviewer does not think it flies, it does not go out the door, and that the reviewer actually gets to look at it before it goes out the door.

Mr. MCDONOUGH. Congressman Sherman, I think that there are various aspects. We will be looking very closely at quality control in the firm. That has a lot to do with the review by the concurring partner.

Mr. SHERMAN. A concurring partner in the same office?

Mr. MCDONOUGH. The reviewing partner.

Mr. SHERMAN. Or a review partner probably in the headquarters office?

Mr. MCDONOUGH. It varies a bit with the firm. Essentially what you want is that there be a quality control in the firm. By the way, we had a very interesting discussion of this in our standing advi-

sory group which advises us on how to look at auditing standards. The person who reviews the engagement partner's work gives what is called a negative assurance. Now, would it be better, and it is a question, and we are not quite sure——

Mr. SHERMAN. I have limited time here. If you have a circumstance where you have a two-partner office and A is reviewing B's work and B is reviewing A's work, that may not assure your objective.

Mr. MCDONOUGH. I believe we would point them in the direction that B should not be reviewing A's work.

Mr. SHERMAN. The way I have seen this best is if a firm has a centralized, maybe not one, but several review departments. But to cut matters short, are you in a position where the reviewing partner must complete a review and if that reviewing partner decides that a clean opinion cannot be issued, that a clean opinion is not issued. Or are you going to allow the client partner to override the reviewing partner?

Mr. MCDONOUGH. In I believe all four of the big firms, first of all, even in the period when Arthur Anderson had that arrangement, the remaining Big Four did not.

Mr. SHERMAN. Are we going to leave it to the Big Four to decide, when they have forgotten Arthur Anderson, to go to a more aggressive marketing model? Or are you going to prevent them from adopting the Arthur Anderson approach or hope that their memory does it for them?

Mr. MCDONOUGH. Oh, of course, of course.

Mr. SHERMAN. So you are going to require that the reviewing partner, that you cannot issue an opinion unless the reviewing partner agrees?

Mr. MCDONOUGH. If the reviewing partner says there should not be a clean opinion, the statute really requires that the reviewers review and approve. That is in the statute. So if the reviewing partner was a patsy, he or she is violating the law.

Mr. SHERMAN. Got you.

Mr. MCDONOUGH. The law is very effective. The other thing we do is we look at who gets paid how much. So if Joe the big business developer is being very well paid, and a good audit review partner is not, we will have a great deal to say to the management of the firm in our inspection.

Mr. SHERMAN. I can say this because I was on track to become a reviewing partner long ago. I have never been so happy since I watched the movie Revenge of the Nerds to hear that the reviewing partners may get paid nearly as much as the client development partners.

[Laughter.]

I say that only because that could have been me.

One of the other things that we saw in the Enron statement is that if you read the financial statements, they beg questions. They were obviously unclear. They hinted that something was being covered up.

One of the ways for you to do your work is to actually read the financial statements and see, because there are limited number of audits where you can go out and look at the working papers. You could read, well, your agency could read the financial statements

of at least the top 1,000 companies. We have urged the SEC to do so as well. Are you reading financial statements and circling the parts where it seems like something is being hidden, particularly in the footnotes?

Mr. MCDONOUGH. Since the SEC does have the responsibility to read them, and they have a much bigger staff than I do, we are now cowering at 202 people. We are, however, starting what we are calling a financial risk analysis group which will start in July. That will be the organization within my shop, but as of July it will have two people in it. We will grow it, as we do the rest of the PCAOB, as rapidly as we can. I think realistically, Mr. Chairman, that we will have to assume that the SEC will just have more eyes to look at them than the PCAOB will for at least a while.

Mr. SHERMAN. Finally, financial auditing is the only game where one of the teams gets to pick the umpire. I do not know whether this is even an idea worthy of discussion, but I will bring it up. I certainly do not know if it would be a good idea. One could imagine at some distant point that your agency, rather than the audited client, selected based on bids and a review of quality and price, which qualified auditing firm did the auditing. Would that be a better system or because then the client would have virtually no power over its own auditor, or should we stick with pretty much the present system?

Mr. MCDONOUGH. The statute really envisions, and I think it is a big step forward, that it is not the CEO/CFO who decides who the outside auditor is, but the audit committee. Now, since that is new, in the real world we do not know how it is going to work. I doubt very much that there is a whole lot of enthusiasm, including by the way on my part, for our selecting who should do the audit, but there is obviously pressure on the audit committees to do their jobs properly so that that does not happen.

Mr. SHERMAN. But the audit committee in many of these companies, every member of the audit committee has stock options and therefore a vested interest in the company showing positive results.

Mr. MCDONOUGH. Yes, but I think that we are going to be able to see whether, perhaps despite that, the audit committees are carrying out their responsibilities to the investors. The law is actually pretty tough, and the PCAOB is certainly not giving any impression to the accounting profession that we are patsies. So I think that there is a new era of Sarbanes-Oxley, of its creation of the PCAOB, and I think we just have to see. A little bit of skepticism might be in order.

Mr. SHERMAN. I am confident that as long as the whole financial world remembers vividly the mistakes that we have just seen that the current structure is likely to work. But when those lessons are forgotten, there may be some backsliding to old cultures. We have seen cycles of this, scandal, people get religion, then people forget it, then people see the immediate financial rewards, and then we go to another series of scandals.

So I think in today's world, audit committees are going to be, dare I say it, religious. I think I have given way too long a homily here. I thank the Chair.

Chairman BAKER. Always a pleasure, Mr. Sherman.

Mr. McDonough, in the hearing, I just had a follow-up question. The Sarbanes-Oxley Act's creation of the PCAOB, the focus on audit independence, on professional conduct by auditors, all are certainly important and significant steps moving us in the right direction.

I am curious, not in your capacity as chair or as a member of PCAOB, but given your general willingness to make a personal observation on matters of some controversy, I am concerned that a retrospective rules-based system in a world which moves so quickly, and even with the best of professional conduct, tells you where the corporation was 91 days or more in the past. It does not really indicate to you where the corporation might be going in the future.

There are certain academic views in the world. A book called Value Reporting was recently written which made some pretty common sense points. Many of your observations are rooted in the "reasonable man" standard. Whether the highest level of accounting methodology is appropriate for a small firm or not ought to be judged by the CEO and the CFO, and other such examples.

I am wondering, not that we should set aside what we have accomplished with Sarbanes-Oxley, but might there not be advisability in examination of and consideration of a more real-time disclosure methodology as perhaps ostensible business reporting language now and pilot by the FDIC; perhaps material fact disclosure; if you are losing a customer that is 30 percent of your income, if you have a need for a particular commodity and the supply is running out, customer satisfaction surveys, people are buying your widget by the thousands, but they are returning them by the thousands.

Should the committee concern itself in going forward about looking at a more forward-looking system, perhaps principles-based as opposed to rules, in providing the kind of disclosure to the markets that really is helpful to markets, as opposed to strictly the current system?

Mr. McDONOUGH. Mr. Chairman, I think the answer is yes, but let me put it in context. I think that one of the most pernicious things that came along in the 1990s was the intense concentration on quarterly earnings and on forecasting quarterly earnings and making the forecasts. It was a terrible development because it is essentially what led to a certain number of companies cooking the books. Some of them were sources of the scandal and some others were probably being aware that on an accounting statement, every number there is an estimate, including cash if you are involved in more than two countries where you have to a currency conversion.

I think what we need to do, and what you suggest would be part of it, would be that all of us have to work on the corporate leadership of America to say what is really important is the future of your company. We ought to be building for the future. If part of the cost of building for that future is that this quarter does not look all that great, responsible, sensible investors should be saying that is good, because that company is going to have a more powerful future.

I started in one of my other activities to say we need about 20 of the greatest companies in America who would decide, we are not going to sweat the quarterly earnings. We are going to build our

company for the future, and since we, let's say you could get 20 of them, that we are going to be the leaders. The investors will say, those are the companies that really make sense. And then getting number 21 to 3,002 is easy because leadership is there.

I think anything that Congress could do which would point in the direction of what is the company going to be like in the future, and then the kinds of disclosures you describe would be very helpful. I think it is much to the good.

Chairman BAKER. When I learned that a tel-com could report revenue in the current quarter from the sale of broad-band capacity for a system that is not yet built, it said to me we may have a great system, but I do not know if it is giving me useful information.

Mr. MCDONOUGH. Precisely.

Chairman BAKER. I think that there has got to be a way to incentivize that type of long-term growth and earnings. I completely agree with the insidious effect of the 90-day earnings report. When you had a brick and mortar company that had never had a loss in the preceding 20 quarters, and they make seven cents instead of eight and they get hammered; then you have a principals-based company with no physical location of operation and they only lose four cents instead of five and their stock price goes up, the world is upside down.

Mr. MCDONOUGH. You bet.

Chairman BAKER. Thank you.

Ms. Maloney.

Mrs. MALONEY. Thank you for holding this oversight hearing. I would like very much to welcome Bill McDonough, who happens to be a constituent, and congratulate him on his really outstanding career in New York at the New York Fed, and now taking on one of the great challenges for the safety and soundness and restoring the confidence in our financial markets.

I know from talking to other New Yorkers, he was offered many, many other positions and he turned them down to take this one because he thought it was very important for the country. I truly do want to welcome you here.

I would like to ask, what do you think about FASB's recent proposal to expense stock options? As one who is really trying to get a good accounting of what is happening, do you think companies should be required to expense stock options?

Mr. MCDONOUGH. Congresswoman, thank you for the kind words. I do, indeed, live in your district and continue to vote there.

[Laughter.]

Mrs. MALONEY. I better behave myself.

Mr. MCDONOUGH. We have an enormously full plate, as you can easily imagine, and accounting policy, which is what we are discussing here, is not part of it. So if you would forgive me doing something which you know is enormously uncharacteristic, I would like to say that since that is the responsibility of FASB and the SEC, that the PCAOB cannot have an opinion on it and should not have an opinion on it, and as Chairman of the PCAOB, ergo, I should not.

Mrs. MALONEY. Okay. Then getting back to Sarbanes-Oxley, which is your responsibility, I hear both sides from my constituents. Some feel that we were not as strong as we should be. Some

firms tell me that is absolutely killing them; that they have to spend millions and millions of dollars on accounting that they feel is in some cases unreasonable.

Could you comment on it? You have been implementing it now. What is your reaction? Do you think we became too strict? Do you think we should be stricter? Do you think we have put too much of a burden on businesses? Could you just give a sense of how you feel about what we did?

I would like to say that Congress does not like to really dictate to the private sector. We want to respect the private sector and support them. They are the engine that runs this country. But when there are abuses, we are forced to act and we try to do it as reasonably and as professionally and as balanced as possible. Were we balanced? Is it working? Were we too strong? Were we not strong enough? Do you have a sense of it for us?

Mr. MCDONOUGH. There were two main products of Sarbanes-Oxley that the business community looked at, the requirement that the CEO and CFO say that the financial statements are accurate or they are in violation of a criminal statute. There was much shock when you passed that, however, everybody has been doing it, and you do not hear very much about it anymore, which I think is a good thing.

What they are concerned about now is the internal control at a station. The management, as you know, has to assess the adequacy of internal controls over financial reporting, and the outside audit firm has to attest to it, which as we established is essentially a second audit of internal controls. Is that justified? For large companies, I think there is no question it is.

Chairman Oxley quoted General Electric, its management said that they had spent $30 million worldwide on the Sarbanes-Oxley Section 404 assessment and they thought it was money well spent. I thought that was a very accurate and sensible statement and much to be applauded. The fact that they said it publicly is the part that should be applauded. I can assure you it was very helpful to us.

In the case of large firms, if they had good internal controls, which they should have had, there is only the additional expense of actually documenting the internal controls. They probably should have had that also. So I am not very sympathetic to any protestations by the large issuers on the cost of Sarbanes-Oxley implementation. I think it is necessary expense, important expense, and the Congress very correctly interpreted the view of the American people that it simply had to be done better.

Especially in response to your colleague, Ms. Velazquez's concerns about the affect on small-and medium-size companies, what we are trying to do is to say that in both the case of the companies themselves and the audit firms, they should be using good judgment. The amount of internal control you need for a small-and medium-size company clearly is not what a big complicated company needs. Therefore, the extent of the internal controls should reflect the reality of the company and the auditor should use good judgment in establishing whether the amount of internal controls put in place are adequate.

If in both cases they say, we passed the test, then our inspectors when they inspect the accounting firm, and if they look at that particular engagement, as I said earlier, I think that they should say, if the company issuer showed good judgment and the audit firm in its attestation showed good judgment, whether our inspector would have done it exactly the same way is not particularly relevant. We should decide whether the judgment that was expressed by the issuer and the auditor were appropriate. If so, it passes.

I think this sort of judgment, also known as common sense approach, which is what we tried to work in to get as much cost-benefit consideration into the statute as we could push it to deliver, that is how we are trying to come up with a realistic, but I think also appropriate under the statute, reaction to not having the stuff become so expensive that it is really making firms spend money that simply is not justified.

Mrs. MALONEY. My time is up. We thank you for taking this very challenging position. Any time you create and put into place something new, it is always particularly a huge challenge. At this time, it is very important to have respect in our markets and the accuracy of them. So I appreciate your work and thank you for being here today.

Thank you, Mr. Chairman.

Chairman BAKER. The gentlelady yields back.

Mr. Sherman.

Mr. SHERMAN. Yes, I wonder if I could ask some additional questions.

Chairman BAKER. Okay.

Mr. SHERMAN. I would like to pick up on where your members of Congress left off, and that is, what can you do as a board to describe, provide examples, provide guidance so that smaller issuers and their accounting firms can tangibilitize your words right here before us that only a reasonable amount of internal control, documentation of internal control, and auditing and proving that the internal control exists and is documented, will be engaged in by small firms? Because there is a tendency, especially in the period right after the falsehoods are revealed in the culture, to go in the direction of saying, well, if GE has to do it, then the small issuer has to do it as well. Are you able to issue some guidance or some explanation so that if GE spends $30 million, that is fine, but some company with $100 million of revenue is not spending $300,000?

Mr. MCDONOUGH. In our auditing standard number two, Congressman, we aligned our internal control standards with the COSO approach. I am very familiar with that because that is what we used at various institutions that I ran before I came to the PCAOB. COSO is a broad, highly flexible framework for internal control that can be used by a variety of companies. It does not require that all companies have the same internal control. It is very flexible.

What is important is that all public companies have effective internal control and we are very much aware that what is needed to be effective at a large company might not be needed at a smaller one. In fact, I would go so far as to say it clearly is not needed.

Mr. SHERMAN. Again, with limited time, there may be some unique circumstances or some companies that have bad internal

control that really need to get their act together, but looking at the average $100 million revenue company in the United States, what should be, under the rules that you are trying to make clear, the costs for the average $100 million a year company to comply?

Mr. MCDONOUGH. We try not to answer that, not to duck, but you could have two companies in two different——

Mr. SHERMAN. I am not saying that any one company can do this. That is like saying, what is the price of an average car. That does not mean you get a Lexus for that price, but for all, say, 1,000 companies that fit that, or hundreds of companies that fit that, not any one, what should be the range? How expensive should this be to the American economy for that sector?

Mr. MCDONOUGH. I really cannot give you a reasonable answer to that, because I want it so much to be that which makes sense for the individual company and not a penny more.

Mr. SHERMAN. But you think if we did that, that the average $100 million company would be spending $500,000 on this?

Mr. MCDONOUGH. I frankly do not know.

Mr. SHERMAN. Okay. I hope that there would be some cost-benefit thinking, and that even if you do not know now, that your board would know.

Mr. MCDONOUGH. You know why I hope you would come to the point of wishing I would not do that? It is because as soon as we put out a number, the company that really does not need to spend that much would think it had to spend that much.

Mr. SHERMAN. Then you would put out a range, would be nice, which would indicate that there are a variety of factors like what industry you are in, not just what——

Mr. MCDONOUGH. Could I leave it if we think that we could put something out that would make sense and be positive, we would do it. I am not sure that we can do it.

Mr. SHERMAN. Okay, because there are a lot of folks who feel they need to do something that I think if you and I looked at it, it would be overboard.

I just want to comment on some of your comments. It would be great to live in a world in which investors did not just look at earnings per share, and did not just look at this quarter's earnings per share. I do not think we will get there. There are so many people who want to trade a stock today; want to compare a stock to any one of 50 other stocks; and want to do it online before they go to work in the morning. Likewise, I hope that the religion, the fear of God inspired by the imprisonment of at least a few, and it has not been enough, will last.

But I would hope that we would build our structure for what happens when the culture gets lazy and the investors stay lazy. I will not say lazy, but stay surface and immediate and quick, because no one wants to hold a stock if they think it is going to go down for a month. They can always buy it back later, unless there is a tax reason, and to think that they are going to say, well, I will ignore quarterly reports. I will ignore the fact that I believe the stock is going to go down for the next 6 months, because I think 10 years from now it is going to be a good stock. There are just a lot of investors who are going to look at quarterly reports, not just annual reports.

Finally, what can you do so that auditors are opining on something other than just a fund statement and income statement and a balance sheet? It is not just how accurately we report that which was decided for the important stuff over a century ago as relevant, and was decided to be relevant for every industry. When are we going to have standards on how auditors can report on employee turnover, backlog, and hundreds of other things where the numbers, I mean, I would rather know some of those numbers than know earnings per share for a quarter about a company.

Will we have standards coming from your shop or elsewhere as to how these audit firms can start opining on something worth opining on?

Mr. MCDONOUGH. I think the first thing you do is change, if necessary, the accounting standards, which is SEC's area.

Mr. SHERMAN. Backing off from this, the accounting standards will say, generally accepted accounting principles will say, here are the rules for creating an income statement; here are the rules for creating. I do not know of anybody who has an accounting standard for defining backlog or employee turnover rates.

Mr. MCDONOUGH. Actually, they could mandate disclosure of anything.

Mr. SHERMAN. They could. You could also say, here is how you audit that, and for different industries, there are going to be different numbers. But an accounting firm, an auditing firm ought to be able to say, here is what we mean by employee turnover for this issuer, or here is what the issuer says it defines it, and we opine that under that definition their employee turnover rate is 3.2 years.

Mr. MCDONOUGH. Congressman, as we work on the auditing standards, which is a huge work in progress, we will have to——

Mr. SHERMAN. I am not saying you have to do it this week.

Mr. MCDONOUGH. We will have to establish what we really think auditors should do.

Mr. SHERMAN. I hope that you would think that they should opine upon and give people confidence in some number that would not be part of the accounting statements issued by every issuer in the year 1901. But rather, that you would give them guidance on how to opine on some of the things that investors today want to know about companies in particular industries.

Chairman BAKER. Mr. Sherman, I just want to point out, it was four or five questions ago when you said "finally."

Mr. SHERMAN. That is a device I use to try to get more time to ask for.

Chairman BAKER. A typical accountant. You drag it out and drag it out.

[Laughter.]

Mr. SHERMAN. It is more like a typical lawyer.

Chairman BAKER. Thank God I am neither.

Mr. McDonough, I just want to express again my appreciation for your appearance here today and commend you for the good work of your own and of the board to date. I particularly am appreciative of your continued repetitive statement concerning the "reasonable man or woman" standard, as the case may be, being the guide by which these decisions are being made.

The consequence of this, however, is because of the manner in which you conduct your business and the board's significant responsibilities for the conduct of corporate reporting, there is a high level of confidence by members of this committee in the work you are doing.

That therefore brings about a significant standard of reliance on your judgments. I would hope that in the course of your future work, that as your findings lead you to conclusions, that the Congress needs to either be informed of or needs to act on, that you would feel quite free in not waiting for the committee to seek out your guidance, but to unilaterally opine at will as warranted for us to be able to work closely with you in this effort.

It is clear to me that our rules do need constant scrutiny; that our current system, and I am going to agree here briefly with Mr. Sherman, does need modification to give the markets the information we really need; and that is a long-term project, as well as doing something about the insidious earnings report. But I wholeheartedly agree with your representations here this morning, and thank you very much.

Mr. MCDONOUGH. Thank you, Mr. Chairman.

Chairman BAKER. Our meeting stands adjourned.

[Whereupon, at 11:52 a.m., the subcommittee was adjourned.]

A P P E N D I X

June 24, 2004

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"Overview of the Public Company Accounting Oversight Board"
June 24, 2004

Less than one year ago, this Committee held a hearing entitled "Accounting under Sarbanes-Oxley: Are financial statements more reliable?" That was the first time that our distinguished witness, William McDonough, appeared before Congress as chairman of the Public Company Accounting Oversight Board.

I am pleased to report that, due in no small part to his exemplary leadership, and that of the other Board members, the answer to the question we posed nine months ago appears to be "yes."

While the problems that led to the passage of the Sarbanes-Oxley Act nearly two years ago have by no means disappeared, the Act's wide-ranging corporate reforms and the effective actions of the PCAOB have helped to restore the faith of America's investors.

In his brief tenure, Chairman McDonough has transformed the Board – the centerpiece of Sarbanes-Oxley – into a rigorous, effective, and highly respected overseer of public accounting firms. The Board has spread a little fear, and Chairman McDonough has hit the proper tough-but-fair tone, in my estimation. He has listened to practical implementation problems and has worked to ease them, provided it does not interfere with Sarbanes-Oxley or the PCAOB's mission. The PCAOB has been a vast improvement in accounting industry regulation.

We will learn today about the inspection process that the Board began during its start-up year of 2003 and the auditing and professional practice standards that the Board has both adopted and proposed. I would particularly like to commend Chairman McDonough for his accommodations on foreign firm inspections.

I am pleased that the Securities and Exchange Commission recently approved the Board's final internal control standard as required by Section 404 of Sarbanes-Oxley. The internal control requirement of the Act has been the focus of some criticism from sectors of the business community. My view is that these costs, although never pleasant, are offset by great benefits.

In implementing the protections of Section 404 and, indeed, all of Sarbanes-Oxley, it is essential that regulators seek to minimize the cost of compliance as much as possible, consistent with the Act's goals. The Board has done exactly that – and we will learn more about that today. At the same time, we must keep the appropriate perspective. According to one report, there were 323 companies that restated their results last year. In 58 of those instances, the outgoing accounting firm reported problems related to internal control. Clearly, the need for strong internal control has not diminished.

Equally important, I am pleased by reports of the positive effects of the internal controls requirements on public companies' business. General Electric's finance chief recently stated, "We have seen value in the [Section] 404 work. It helps build investors' trust and helps give them more confidence. We've gotten positive benefits from it." This is precisely the purpose of this requirement.

There is much more work to be done. But I remain confident that Chairman McDonough and his colleagues will continue to ensure that financial statements are more reliable.

I welcome you back, Chairman McDonough, and look forward to your testimony.

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June 22, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing on Oversight of the Public Company Accounting Board

Thank you, Mr. Chairman, for holding this important hearing and allowing us this opportunity to review the progress made by the Public Company Accounting Oversight Board (PCAOB or Board). I would also like to thank Chairman William J. McDonough for making himself available to us this morning and for his strong leadership as the first Chairman of the PCAOB.

The Sarbanes-Oxley Act of 2002 created the PCAOB to bring an end to the self-regulation of the accounting profession. The Board is now tasked with protecting the interests of investors and furthering the preparation of informative, fair, and independent audit reports. The PCAOB is required to register public accounting firms; establish auditing, quality control and ethics standards proposed by a designated professional group of accountants; inspect registered firms; and conduct investigations and disciplinary proceedings and impose sanctions upon registered firms and accountants.

I look forward to hearing from Chairman McDonough today on the Board's progress in setting up their operations and implementation procedures to fulfill their important responsibilities in protecting investors.

I would also like to join Chairman Oxley in his praise of the PCAOB and Securities and Exchange Commission (SEC) for their successful completion of one of the main tasks set for them in the Sarbanes-Oxley Act; finalizing a rule requiring companies to include in their annual reports a report by management on the company's internal control over financial reporting and an accompanying auditor's report. This is a win for America's shareholders and important step forward in ensuring the appropriate checks and balances in accounting and auditing systems are realized.

Thank you again, Mr. Chairman, for holding this important hearing and I look forward to an informative session.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON OVERSIGHT OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

THURSDAY, JUNE 24, 2004

Mr. Chairman, nearly two years ago after a spate of corporate accounting scandals we adopted the Sarbanes-Oxley Act. As you know, I was intimately involved in every stage of this law's development, from the first congressional hearings on the collapses of Enron and WorldCom through the final meeting of our bicameral conference committee.

In addition to imposing new obligations on issuers, executives and directors, a key section of this historic statute replaced self-regulation by the accounting industry with an independent, full-time entity known as the Public Company Accounting Oversight Board to monitor the entities that audit public companies. This board regulates firms, both foreign and domestic, that audit companies whose securities are publicly traded.

Today, we are fortunate to again have before us William McDonough, the head of the Public Company Accounting Oversight Board. Just last week, the board issued its first annual report and his testimony today will help us to better appreciate his organization's hard work in turning a functional statutory outline into an active regulatory system. This hearing will also help us to understand the progress that the board has made in bolstering investor confidence, restoring the integrity of financial statements, and rebuilding trust in our securities markets.

In closing, Mr. Chairman, we cannot and should not remove the risks associated with investing. Our capital markets work well because of that risk. We should, however, ensure that every corporation plays by the rules, that all investors have access to the reliable information needed to make prudent decisions, and that each party who violates our securities laws is held accountable. As the Public Company Accounting Oversight Board continues its work to achieve these objectives, it is appropriate for us to review its progress.

Testimony Concerning
The Public Company Accounting Oversight Board

William J. McDonough
Chairman
Public Company Accounting Oversight Board

Before the Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises,
Committee on Financial Services,

United States House of Representatives

June 24, 2004

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am pleased to appear today before the House Financial Services Committee's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board").

I want to begin by taking a moment to thank the Subcommittee for its strong bipartisan support of our organization. We benefit greatly from your wisdom and encouragement, and from our strong and positive working relationship. We work hard to earn your confidence, and to push toward full realization of the objectives the Congress set for us, less than two years ago, with passage of the landmark Sarbanes-Oxley Act of 2002 (the "Act").

With that Act, Congress took a giant step toward restoring shaken investor confidence in financial reporting and auditing of public companies. The Act did not merely create a regulatory environment conducive to investor protection; it also reflected the powerful demand of the American people for fairness and honesty from those participants in the U.S. markets who benefit from the people's investments. Close to half of all households in America have invested in our securities markets,[1/] and the volume of resources those investments provide to business is a driving force behind the U.S. economy. The more confidence that investors have in the financial information

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[1/] Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," Federal Reserve Bulletin January 2000.

available to them about the issuers of securities, the more resources they will pour into our businesses, both large and small.

No one should doubt that it is the faith of those investors – not the freedom of corporate managers from public regulation and oversight – that fuels the growth and competitiveness of our economy.

Introduction

Over the last 18 months, we have turned the Sarbanes-Oxley blueprint into an operating organization. Today, the PCAOB is well on its way to maintaining, as required in the Act, a continuous program of auditor oversight "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[2/]

Specifically, the Board's powers include authority to –

- register public accounting firms that prepare, or substantially contribute to the preparation of, audit reports for public companies;
- conduct inspections of registered public accounting firms in connection with their public company auditing practices;
- conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms; and
- establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports on the financial statements of public companies.[3/]

[2/] Sarbanes-Oxley Act, Section 101(a).

[3/] Sarbanes-Oxley Act, Section 101(c).

The Board executes this authority through, and with the assistance of, three major operating units – Registration and Inspections, Enforcement and Investigations, and Professional Standards. We have also hired staff for key support functions, including human resources, information technology, finance, public affairs, government relations, legal advice, and international policy. In addition, we have established an office of Internal Oversight and Performance Assurance, which conducts internal examinations of the Board's programs and operations – using the same U.S. General Accounting Office ("GAO") *Yellow Book* standards that are used in performance reviews of government agencies –to help ensure efficiency, integrity and effectiveness in those programs and operations.

The Board has hired a staff of 200 auditors, analysts, attorneys, and others, including staff to fill all the top positions, and we plan to continue to grow and expect to be close to 300 employees by the end of this year. Most of our staff is based in our headquarters in Washington, D.C., and we have offices in New York City and the Atlanta, Dallas, and San Francisco areas to support our ongoing inspections of registered accounting firms. We also have an office near Dulles, Virginia, to support our significant investments in technology, and we expect to open offices in the Chicago area and Southern California in the near future.

With that brief background, let me now turn to a more detailed description of the ways in which our new organization has been energetically implementing the confidence-restoring regime established in the Act.

Registration of Public Accounting Firms

Registration of public accounting firms that audit public companies is the foundation of the Board's authority. Since October 22, 2003, it has been illegal for any U.S. public accounting firm to prepare, issue, or play a substantial role in the preparation or issuance of, an audit report on the financial statements of a U.S. public company unless it is registered with the Board. As of July 19, 2004, the same restriction will apply to non-U.S. firms that prepare, issue, or play a substantial role in the preparation or issuance of, audit reports on the financial statements of U.S. public companies. As of June 22, we have registered 976 U.S. and non-U.S. public accounting firms that audit or may wish to audit U.S. public companies, and we continue to receive applications from both U.S. and non-U.S. firms.

Although a registration requirement has the potential to result in the most bureaucratic of processes, the Board instead chose to fashion a dynamic, relational registration database under an aggressive development schedule. Given the limited time to register firms by last October 22, the conservative approach would have been to require each firm to submit a paper form containing the required registration information. Using a paper system, we certainly would have been able to complete the registration process by our deadline, but we would have lost a significant opportunity to capture the data that applicants submitted in a form that could be used long after registration for complex, relational risk analysis in all our programs.

Instead, the Board developed a system that would allow us to use the data we receive in the registration process to support our other programs. In approximately six months, our Office of Information Technology built a completely new Web-based registration system from the ground up. At the same time, we developed rules relating to the registration process; thus the system development and our rulemaking progressed on parallel tracks. I am pleased to report that our system has worked well throughout the eleven months during which we have processed and considered almost 1,000 applications, many of which include large amounts of information.

Registration is not automatic. The Board considers each application and gives special attention to those firms that have received negative peer reviews, been subject to disciplinary proceedings (against the firm or its principals), or reported unusually high ratios of public company audit clients to accountants employed at the firm. To grant approval, the Board must determine that registering the applicant is consistent with the Board's responsibilities to protect investors and to further the public interest in the preparation of informative, accurate, and independent audit reports. Once we have registered a firm pursuant to this standard, we continue to use our analysis of its strengths and weaknesses in our inspection risk assessment process.

I would like to tell you a little about what we have learned about the landscape of the public company auditing field. Four of the 976 registered firms are the so-called Big Four, and they audit more than 78 percent of all U.S. public companies, and their clients

produce almost 99 percent of public company sales revenue.[4] Only eight U.S. firms have more than 100 public company audit clients:[5]

Firm	Number of U.S. Public Company Clients [6]
PricewaterhouseCoopers LLP	3,234
Deloitte & Touche LLP	3,092
Ernst & Young LLP	2,856
KMPG LLP	1,893
Grant Thornton LLP	420
BDO Seidman, LLP	234
Crowe, Chizek and Company LLC	135
McGladrey & Pullen, LLP	114

These firms audit the vast majority of the financial statements that investors read and rely on. In addition to these firms, we also have 804 U.S. firms and 164 non-U.S. firms within our registry, many of which are far smaller in size than the top eight firms. Of these other firms, 863 have fewer than 10 public company audit clients, and about 268 registered firms have none at all. This distinction poses challenges to us to develop

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[4] See United States General Accounting Office, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, Public Accounting Firms, Mandated Study on Consolidation and Competition, July 2003, GAO-03-864.

[5] Only one non-U.S. registered firm audits the financial statements of more than 100 U.S. public companies. Firms that have more than 100 public company audit clients are subject to annual inspections. See Rule 4003(a). Firms that have between one and 100 such audit clients are subject to regular inspections every three years. Ibid.

[6] 2002 data.

appropriate inspection programs that take into account the differences in size, complexity, and nature of risk of registered firms.

Inspections of Registered Firms

Once a firm is registered, it is subject to Board inspections. The Act and the Board's rules require annual inspections of the firms that audit more than 100 public companies and triennial inspections of the remaining registered firms that have at least one U.S. public company client.[7] The Board also has the authority to conduct special inspections, as necessary, to address issues that come to the Board's attention.[8] Inspections will use the greatest portion of the Board's resources, largely because of the need for a sizable, well-trained staff. Today, our inspections staff includes more than 80 auditors, and we expect to have 130 to 160 later this year.

Our inspections take up the basic task that had been the province of the profession's peer review system, but our inspections go much further than peer review ever did. Under the peer review system, reviewers focused on technical compliance with professional accounting and auditing standards and, on the basis of that review, opined on overall quality control. We begin by looking at the business context in which audits are performed. We focus on the influences – both good and bad – on firm practices. These include firm culture and the relationships between a firm's audit practice and its other practices and between engagement personnel in field and affiliate offices and a firm's national office. By doing so, we believe that we will gain a much

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[7] See PCAOB Rule 4003(b).

[8] See PCAOB Rule 4002.

better appreciation for the practices and problems that led to the most serious financial reporting and auditing failures of the last few years.

2003 Limited Procedures

Although the regular inspection cycle began this year, in order to earn the confidence of the investing public, we launched our inspection program in our start-up year of 2003 with "limited procedures" inspections of the Big Four firms. The Board's inspections teams for these inspections included seasoned auditors, who have an average of 12 years of auditing experience. Our inspection team leaders each have an average of 22 years of auditing experience.

The focus of those first-year inspections was to conduct a baseline assessment of the firms' internal systems of quality control over auditing. A firm's quality control system provides assurance to investors and others that rely on auditors' opinions that a firm's auditors comply with professional auditing and accounting standards. Firm culture – including, for example, the "tone at the top" that management infuses into the organization, and the system by which partners and employees are compensated and promoted – is one of the most important elements of a quality-control system. The quality-control system also includes internal controls over decisionmaking relating to auditing issues and internal reviews of audit engagements. In addition, we examine individual engagements to test whether the quality-control system is working.

Under the Act and our rules, we will make a draft of our report on an inspection available to the firm under review and the firm has 30 days to respond to the draft.[9] The Board will then finalize the report and deliver it to the Securities and Exchange Commission ("SEC") and, in appropriate detail, to appropriate state regulatory authorities.[10] We will also make certain portions of each report public, although the Act requires us to keep any criticisms of, or potential defects in, a specific firm's quality-control system confidential, so long as the firm corrects the problems identified within 12 months after the date of the report.

We have made our draft 2003 limited procedures inspection reports available to the four firms, and we are now awaiting their responses. As noted above, these inspections were more limited than our full inspections will be in this and future years. Nevertheless, we learned a great deal about quality control in the largest firms. In numerous interviews, we heard audit partners and staff express their perceptions of a renewed focus on audit quality. We have seen some evidence of this renewed focus in firm policies generally, and in internal firm communications about those policies. Even so, we alerted the firms to quality control concerns that we have formed, on the basis of our limited inspections, and we will continue to look hard at whether the firms' conduct mirrors their words.

In that regard, we have also learned that there is tremendous value in reviewing audit engagements, particularly with respect to inspections of larger firms. As one

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[9] See PCAOB Rule 4007(a).

[10] See PCAOB Rule 4008.

would expect of sophisticated organizations, each of the firms has developed multiple volumes of quality-control policies, but individual engagements are the litmus test for whether the firms are in fact conducting high quality audits. Although we only reviewed a small number of engagements in 2003, we identified significant audit and accounting issues. As we examine even more engagements in the future, we expect the prospect of scrutiny in our inspections to alter the relative risks and rewards to individual engagement partners who might otherwise consider shortcutting audit steps or bending to pressures to please clients.

Our inspections also provide valuable information about the need for enhanced standards. For example, although the limited number of engagements reviewed in 2003 prevented the Board from drawing conclusions about systemic deficiencies in audits, we formed a concern that auditors may place insufficient emphasis on the importance of thorough documentation of audit work. The Act expressly required us to adopt an auditing standard on documentation, and we began work on such a standard while we were conducting our limited procedures. We were able to use knowledge about existing documentation practices that we gained in our limited inspections to develop the new standard. We expect this new standard to drive significant improvements in audit quality, and we intend to monitor these improvements in future inspections.

2004 Inspections

We have now embarked on our 2004 full inspections of the largest U.S. firms.[11] In addition, we will inspect a great number of small U.S. firms. We began the fieldwork for these 2004 inspections in the first week of May, and we will continue these inspections through November. We will focus on, among other things, efforts to detect fraud; control over compliance with independence requirements; the adequacy of documentation; efforts to identify, evaluate, and manage risk; and compliance with professional auditing and accounting standards. In order to capture a significant sample of engagements at each firm, we plan to review approximately five percent of the Big Four firms' public company audits – that is, more than 500 audits – and 15 percent of the next four largest firms' public company audits – or, about 150 audits. That adds up to more than 650 audits, in addition to the small-firm audits that we will select on a case-by-case basis.

Auditing and Related Professional Practice Standards

By virtue of the Act, for the first time, those developing auditing standards – our Board Members and staff – will have access to robust empirical and anecdotal evidence from inspections and enforcement activities to set priorities and to identify needs to develop or amend standards. We have already embarked on an aggressive agenda that is aimed at strengthening auditing standards in areas that were of particular concern to the Congress, as expressed in the Act, and in areas that we identify

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[11] The only non-U.S. registered firm that audits the financial statements of more than 100 U.S. public companies did not register until 2004. Therefore, under the Board's rules, full inspections of that firm will begin in 2005. See PCAOB Rule 4003(a).

internally through our inspections or externally through outreach to investors, auditors, regulators, managers, academics and others.

First, as required by the Act, we adopted interim auditing standards that auditors have had to follow since we received our authority. The Board adopted as interim standards of the Board the body of auditing standards that had been developed by the profession, through the American Institute of Certified Public Accountants, as those standards existed on April 16, 2003. At the same time, we announced that we would review all of the interim standards and would determine, standard by standard, whether they should be modified, repealed, or made permanent. This will, of course, be a long-term project.

Second, the Board has developed and adopted three new standards – on references to PCAOB standards in audit reports, on auditing internal control over financial reporting, and on audit documentation. Our auditing standard on internal control implemented a significant requirement of the Act. Section 404 of the Sarbanes-Oxley Act, and the SEC rules implementing it, require corporate managements to issue annually a report on the effectiveness of the company's internal control over financial reporting. The Act requires the auditor, in turn, to report on management's conclusions.[12/]

Our internal control standard is one of the most important and far-reaching auditing standards the Board will ever adopt. Whereas in the past auditors were required merely to consider internal control, not test it, now auditors must examine in

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[12/] See Section 103(a)(2) and 404(b) of the Act.

detail and report on whether internal control over financial reporting is designed and operating effectively. Good internal control is also one of the most effective deterrents to fraud, and therefore we expect our standard to help protect investors from the kinds of financial reporting scandals that the Act seeks to prevent.

As we developed our standard on internal control, we paid careful attention to avoiding a one-size-fits-all approach to internal control. Rather, our standard provides for flexibility in considering internal control at companies of different size and complexity. A small company with a simple financial reporting structure will not need the complex procedures governing financial recording and reporting that a large, multinational conglomerate will need to have strong internal control over financial reporting. Section 404 and the Board's requirements will entail extra work and, for companies, extra expense, however, particularly in the first year of implementation. Companies that had good internal control to start with will experience less of an implementation burden than those that did not, and companies that have materially weak internal control at the time of the internal control audit will, under Section 404 and the Board's standard, receive an adverse auditor's report on internal control.

This is an important point. Once the SEC's rule and the Board's standard go into effect, investors will receive information that they have never seen before. Some of those reports will describe material problems with a company's internal controls over financial reporting. In such cases, both management's report on internal control and the auditor's report on internal control should contain important disclosures explaining the

nature of the weakness, which investors should consider in evaluating those financial statements.[13]

In addition to developing these standards, the Board has established a Standing Advisory Group to provide advice on future standards-setting projects. The Board announced this 30-person advisory group in April, and we held the first meeting of the group earlier this week. We see this group as an important tool to obtain insight about ways to improve audits by developing clear and effective auditing standards, and so we have included in the group individuals with deep experience as auditors, financial statement preparers, investors, and academic researchers, among others.

We also seek information from practitioners and others on issues that arise in practice in the context of implementing our new standards, to better understand and resolve questions that may arise. For example, we convened informal working groups of auditors and corporate personnel involved in implementing our standard on internal control. We use information we gather in these sessions to identify points on which it may be useful for us provide guidance to auditors and others on how to implement our new standards, as needed.

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[13] An auditor may be able to issue an unqualified audit report on a company's financial statements, notwithstanding an adverse opinion on the company's internal control over financial reporting. Today, auditors that determine that a company's internal control over financial reporting is inadequate may nevertheless be able to reach an unqualified opinion on the fairness of the company's financial statements by performing more substantive procedures. Similarly, once the Board's standard is in effect, an auditor of a company that has materially weak internal control may, based on additional audit procedures, determine that the company's financial statements are fairly presented in accordance with generally accepted accounting principles. The difference is that under the SEC's new rule and the Board's new standard the additional disclosures on the weakness of internal control will provide investors with new and useful information on which to base their judgments about the financial statements.

Looking forward, we face a challenging near-term agenda, notwithstanding the achievements we have already made. Two important standards-setting projects expressly required by the Act are yet to be done. Those relate to second partner review of specific engagements and to overall quality control over compliance with professional accounting and auditing standards. We also plan to develop a comprehensive standard to address auditors' responsibilities for communications and relations with audit committees. Such a standard would incorporate requirements mandated under the Act into the audit and related professional practice standards. In addition, we will consider auditor independence and particular non-audit services, such as tax services, in the post-Sarbanes-Oxley environment. In this regard we will be holding a public roundtable meeting on tax services and auditor independence on July 14.

While the Act requires auditors to follow our standards only when they are performing public company audits, we hope that our Standards will come to be followed in other contexts. While some public companies do go private, in many more cases private companies go public. In addition, stakeholders other than public investors – such as lenders – have already begun to require auditors to provide audit reports according to our standards. For these reasons, we hope our standards can be applied uniformly in a variety of contexts. With this objective in mind, the PCAOB will monitor closely the standards-setting of the GAO and the International Auditing and Assurance Standards Board ("IAASB").[14/]

[14/] The IAASB is a profession-organized group whose auditing standards serve as the basis for the standards auditors use in many countries.

I cannot conclude my discussion of our standards-setting activities without acknowledging the international aspects of our work. International convergence on high-quality standards is an important objective. As a first step in this direction, we have reached out to the IAASB – by, for example, seeking and receiving an observer seat at IAASB meetings – to increase the likelihood that international standards will develop in a direction we see as positive. Our observer seat will also increase the likelihood that international views find a place in the PCAOB's standards, and in that regard we have also invited the IAASB to participate as an observer with speaking rights on our Standing Advisory Group. In addition, we plan to consider relevant international standards on auditing in our standards-setting development projects. For example, we are studying closely the IAASB's new quality control standards in connection with our development of new standards on concurring, or second partner, review and on overall quality control.

Enforcement

The Board will address many of the auditing problems we identify through a combination of standards-setting and supervision through the inspection process. Situations will inevitably arise in which those tools are inadequate, however. When we find serious violations of PCAOB standards or the securities laws by auditors under our jurisdiction, we will use the authority the Act gives us to investigate and, as appropriate, to seek disciplinary sanctions. Those sanctions can include significant monetary penalties, and also may include revoking a firm's registration (and thus preventing it

from auditing public companies) or suspending or barring individuals from working on the audits of public companies. Our authority to investigate includes authority to seek relevant documents and testimony from auditors and others, including client personnel. Because audit failures typically have an impact on the reliability of the financial statements the auditor was responsible for examining, we expect our investigations will often be a component of a larger investigation of the financial reporting itself and management's role in that reporting. We therefore expect to work very closely with the SEC in such cases.

Oversight of Non-U.S. Accounting Firms

Under Section 106(a) of the Act, non-U.S. firms are subject to the Act and to the rules of the Board "to the same extent as a public accounting firm that is organized and operates under the laws of the United States." As I mentioned earlier, we have registered 164 non-U.S. firms.[15/] At this point, we expect that as many as 400 non-U.S. firms may register with the Board.

The Board has given considerable thought to how our oversight programs should operate in relation to non-U.S. firms that audit or play a substantial role in auditing U.S. public companies. Last October, we issued a briefing paper that describes a framework for oversight that depends, to the greatest extent possible, on cooperation among

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[15/] Title I of the Act is directed toward the auditors of public companies that seek to raise capital in U.S. markets. In the United States, the Act directly affects as many as 15,000 U.S. public companies. Those companies are headquartered in the United States, but they often have significant operations in other countries as well. The securities of about 1,400 non-U.S. public companies trade in U.S. securities markets, and so those companies must also follow many of the requirements of the Act, including the requirement to file with the SEC financial statements audited by a registered public accounting firm.

regulators. That paper fostered an international dialogue that contributed to the development of a landmark European proposal for an independent auditor oversight regime in Europe and to an unprecedented confluence in Brussels this past March of auditor oversight bodies from every European member state to discuss with us how we can mutually improve the quality of auditing on both sides of the Atlantic.

We have also had fruitful discussions with auditor oversight authorities in Canada, and in a number of other countries, including France, Switzerland, Germany, Australia, and Japan. We hope to be able to rely to a great extent on the inspection work of other regulators, and it is in that regard that we especially welcome the establishment of new, independent oversight systems outside the United States.

Our ability to work with and rely on our counterparts will necessarily depend upon whether we are able to develop arrangements among regulators concerning inspection programs for non-U.S. firms. Earlier this month, we adopted final rules to implement the concepts we put forward in October, which will give us the flexibility to fashion arrangements for joint work programs and other procedures that are appropriate to the circumstances, given the differences in regulatory structures throughout the world.

Conclusion

During the last 18 months, we have established a strong operational foundation for our statutory programs, but we still have many challenges ahead. Some of our most significant challenges in the next year will be to complete our first full inspections of the largest public accounting firms; to review our interim auditing and related professional

practice standards and, where needed, to develop new standards; and to establish cooperative oversight programs with our counterparts in other countries.

We will continue to push forward, step by step, toward the world envisioned in the Act. It is a world in which public accounting firms are strong, reliable businesses that compete based on virtue. It is a world in which the investing public has enough confidence in the fairness of our capital markets – and in the auditors who stand in their place – to invest their and their children's futures in those markets. And it is a world in which U.S. companies have access to rich capital markets funded by those investors, to grow new businesses, to develop new products, and to hire new employees.

Thank you for the opportunity to describe our progress toward this goal.

PCAOB

Public Company Accounting Oversight Board

Restoring Confidence

2003 Annual Report

The Public Company Accounting Oversight Board is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

PCAOB
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June 23, 2004

Dear Members and Staff of the House Committee on Financial Services:

On behalf of the Public Company Accounting Oversight Board (PCAOB), we have attached a copy of our inaugural annual report. It has been an exciting time for the PCAOB as we pursue the objectives Congress set forth for us in the Sarbanes-Oxley Act of 2002.

"To oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports."

We join Chairman William J. McDonough in thanking Members of Congress for your support of our efforts, and encourage you to review this annual report, which sets forth the challenges and achievements of our first year of operation.

The PCAOB Office of Government Relations is pleased to serve as the contact point for any inquiries you may have. Please direct any calls or correspondence to our attention at the phone number and address below. We are here to serve you and look forward to working with you as we pursue our joint goals of protecting the investing public.

Sincerely,

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Public Company Accounting Oversight Board

Bill Gradison
Board Member

William J. McDonough
Chairman

Kayla J. Gillan
Board Member

Charles D. Niemeier
Board Member

Daniel L. Goelzer
Board Member

Letter from the Chairman

I am pleased to present the annual report of the Public Company Accounting Oversight Board, recounting the accomplishments of the Board in the first year of operation of this remarkable organization.

What you will read in these pages is the story of the creation of an unparalleled regulatory body, charged by federal law to build a system of oversight that had never before existed, entailing the registration of public accounting firms, regular inspections of those firms, and provisions for the investigation and discipline of accounting firms that betray the public trust in their audits of publicly traded companies. This new body is required by federal law to set the standards that guide the audits of publicly traded companies and to establish and implement the funding structure that supports its activities.

The events that led Congress to take the radical step of ordering a new oversight regime for the accounting profession are well known: Beginning with the collapse of Enron in late 2001, investors and the American public were beset by a series of corporate failures that undermined confidence in U.S. securities markets and pointed to deep flaws in both corporate and regulatory governance.

The role of auditors in those corporate collapses caused the American people and their representatives in Congress to question—and reject—the existing system for policing of accounting firms, and the Public Company Accounting Oversight Board was conceived.

The PCAOB became reality on July 30, 2002, when President George W. Bush signed the Sarbanes-Oxley Act into law.

In addition to creating new oversight of auditors of public companies, the Act prescribed specific steps to address specific failures and codify the responsibilities of corporate executives, corporate directors, lawyers and accountants.

The merits, benefits, cost and wisdom of each of the prescriptions continue to fuel debate. But the context for the passage of the Sarbanes-Oxley Act, and the President's signing it into law, cannot be ignored: Corporate leaders and advisors failed. People lost their livelihoods and their life savings. The faith of America and the world in U.S. markets was shaken to the core.

To help restore faith in the audits of public companies, the Act first required the appointment of the Public Company Accounting Oversight Board, comprising five members "who have a demonstrated commitment to the interests of investors and the public."

I hope that this report on the first year of the PCAOB will leave you with the conviction that not just the Board members, but the entire staff of this new organization have indeed demonstrated their commitment to the interests of investors and the public. None of what is described in these pages could have been accomplished without the dedication and self-sacrifice of a staff that numbered a mere 25 people a year ago.

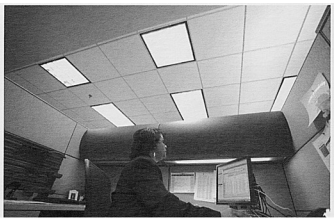
You may have noticed the lack of a salutation on my letter. We are a private-sector, nonprofit organization, so addressing "shareholders," as you might see in the annual report of a public company, would not be appropriate. The law, in fact, requires that we submit our annual report to the Securities and Exchange Commission, which will then transmit a copy to the committees that created the PCAOB in the U.S. Congress.

I thank our colleagues at the SEC and the members of Congress whose support undergirded our efforts. I believe they would join me in submitting the first annual report of the PCAOB to the people, in the United States and around the world, who look to U.S. securities markets as a model for fairness and reliability. The people will ultimately judge how well we at the PCAOB have done our jobs. I humbly submit that we have done our best to fulfill that awesome responsibility in this first year and that we will continue to do nothing less in the years to come.

William J. McDonough
Chairman and Chief Executive Officer
Public Company Accounting Oversight Board
Washington, D.C.

June 2004

Creation



With President Bush's signature on July 30, 2002, the Sarbanes-Oxley Act became law, and an unprecedented oversight organization was created.

The Act established an independent, nonprofit, non-governmental body to oversee the auditors of publicly traded companies "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

To accomplish this mission, the Act gave the new oversight body four primary responsibilities:

- Registration of accounting firms that audit public companies trading in U.S. securities markets;
- Inspection of registered accounting firms;
- Establishment of standards for auditing, quality control, ethics, and independence, as well as attestation, for registered accounting firms; and
- Investigation and discipline of registered accounting firms and their associated persons for violations of law or professional standards.

The Act required the Securities and Exchange Commission to select a Board made up of "individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public…"

The Commission named the founding members of the Board on October 25, 2002.

From then on, it was up to the Board to take all necessary action, "including hiring of staff, proposal of rules and adoption of initial and transitional auditing and other professional standards," that would enable the SEC to determine that the PCAOB had the capacity to meet the requirements of the Act.

The Act set the deadline for the SEC's determination at April 25, 2003. The Act also gives the SEC oversight authority over the Board. In addition to appointing or removing members, the SEC, among other things, must approve the Board's budget and rules, including auditing standards, and may review appeals of adverse Board inspection reports and disciplinary actions against registered accounting firms.

With the assistance of a handful of staff members, founding Board members Kayla J. Gillan, Daniel L. Goelzer, Bill Gradison and Charles D. Niemeier opened the doors of the PCAOB's first offices on January 6, 2003. The Board held its first public meeting on January 9, 2003, where the members adopted bylaws for the organization and announced an aggressive campaign to hire the staff that would enable the Board to fulfill its mission.

At a series of public meetings in March and April, the Board proposed its rules for the registration of accounting firms, including non-U.S. firms, adopted interim auditing standards and related standards for professional practice, proposed its ethics code, and submitted its Fiscal Year 2003 budget to the Commission.

> There is established the Public Company Accounting Oversight Board…
>
> Title I, Sec. 101(a), Sarbanes-Oxley Act of 2002

In March, the Board also proposed the establishment of the accounting support fees that would finance the PCAOB's operations in future years. These fees, as provided in the Act, are to be paid by publicly traded companies and mutual funds—guaranteeing that the Board's funding would be independent of the accounting profession as well as the federal government.

The Board organized its internal divisions and offices to match the responsibilities it was assigned by the Act. The Division of Registration and Inspections was charged with building the registry of accounting firms and preparing for inspections of the firms. The Office of the Chief Auditor and Professional Standards was created to advise the Board on standards-setting. The Division of Enforcement and Investigations was formed to perform investigations of possible violations of law or professional standards and to recommend to the Board any disciplinary action.

To support the primary functions required by the Act, the Board created other key offices. The Office of General Counsel was established to provide legal advice and assist the Board's rulemaking functions. The Office of Administration was given responsibility for three areas that

would be vital to the Board's success: information technology, which developed the technology infrastructure to support all of the Board's programs, including the Web-based registration of accounting firms; human resources, tasked with hiring the dozens of inspectors and other staff needed to carry out the PCAOB's work; and the office of finance, which would administer the accounting support fees, among other things.

On April 25, 2003, six months after the founding Board had been named, the SEC issued the determination required by the Sarbanes-Oxley Act. The members and staff of the PCAOB had demonstrated that they could fulfill the responsibilities of the Sarbanes-Oxley Act.

On May 21, 2003, the SEC unanimously approved the appointment of William J. McDonough as Chairman of the PCAOB.

The Board and the staff aggressively addressed the next deadline imposed by the Sarbanes-Oxley Act: the registration of public accounting firms. Under the Act and the Board's rules, after October 22, 2003, only registered U.S. accounting firms could audit or substantially participate in the audit of a publicly traded company. Through the summer of 2003, the Board's information technology team completed the construction of the Web-based system for registration. The SEC approved the Board's rules and form for registration on July 16, 2003. Registration applications were available online beginning July 17, and by October 22, the Board had approved the registration of 598 firms. Applications continued to arrive after the October 22 deadline, and by December 31, the Board had approved the registration of 735 firms.

The Act requires a continuing program of inspections of registered public accounting firms that audit public companies. In mid-2003, even though the largest firms were not yet registered, the Board launched limited inspections of those four firms in the belief that investors and the public would best be served by immediate inspections to help restore investor confidence in public company auditing. After seeking and considering public comment, on October 7, 2003, the Board adopted the rules that would guide the inspections of all registered accounting firms—annual inspections for firms with more than 100 public company clients and inspections no less frequently than every three years for other firms—as well as special inspections. To accomplish the inspections, the Board opened an office in New York in September 2003 and began hiring staff for additional offices near Atlanta, Dallas, and San Francisco. The Board paid close attention to hiring a cadre of experienced auditors to conduct the inspections, and by year's end, the PCAOB inspection staff had grown to 60.

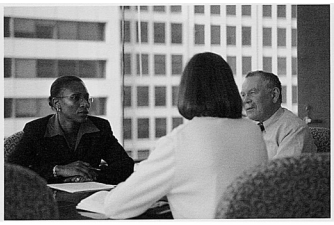
While registration and limited inspections were under way, the Board, through its Office of the Chief Auditor and Professional Standards, began addressing the momentous task of developing standards for the audits of publicly traded companies. The Board held two roundtable discussions with investors, issuers, and auditors to discuss standards for audits of internal control and audit documentation, and it adopted rules for the establishment of a standing advisory group to provide guidance on standards-setting. On October 7, 2003, the Board proposed the most complex standard required under the Sarbanes-Oxley Act: the standard for auditors' attestation to management's assessment of internal control over financial reporting.

The proposal of the internal control standard was one of almost a dozen rulemaking actions taken by the Board in the last half of 2003. The Board also proposed or adopted rules for inspections of accounting firms, for investigations and adjudication, and for oversight of non-U.S. accounting firms that audit U.S. public companies.

During the year, the Board also established offices of public affairs and government relations to assist the Board in communications with the public, Congress, and the news media. The Board also hired an international affairs staff to advise the Board on international issues and facilitate dialogue with foreign regulators regarding oversight of registered non-U.S. accounting firms. The Board also began hiring the staff for investigations and enforcement.

Four Board members and a handful of staff members had opened the doors to the organization's first office on January 6. By December 31, the organization was 118 strong. The Public Company Accounting Oversight Board was well established and well on its way to fulfilling its statutory duties to investors and the public.

Registration



Before the Sarbanes-Oxley Act of 2002, the accounting profession largely operated outside the purview of national oversight. Individual accountants were subject to the education and certification requirements of the states in which they practiced, and accounting firms voluntarily participated in self-regulation through a national professional organization. Federal securities laws set certain requirements for and limits on the work of auditors of publicly traded companies, but none of the federal or state regulations approached the regime of oversight set out by the Sarbanes-Oxley Act.

The requirements of the Act compelled the Public Company Accounting Oversight Board to construct an unprecedented registry of domestic and non-U.S. accounting firms that audit, or play a substantial role in the audits of, public companies and mutual funds. With registration, accounting firms become subject to the Board's inspections, auditing standards and enforcement authority.

The Board proposed its rules for the registration of public accounting firms on March 4, 2003—just two months after the Board began operations. The proposed rules sought the information required of such firms under the Sarbanes-Oxley Act, including:

- The names of all issuers for which the firm prepared or issued audit reports during the immediately preceding calendar year, and for which the firm expects to prepare or issue audit reports during the current calendar year.
- The annual fees received by the firm from each issuer for audit services, other accounting services and non-audit services, respectively.
- A statement of the quality control policies of the firm for its accounting and auditing practices.
- A list of all accountants associated with the firm who participate in or contribute to the preparation of audit reports.
- Information relating to relevant criminal, civil, or administrative actions or disciplinary proceedings pending against the firm or any associated person of the firm.

The Board, in its proposed rules, sought a limited amount of supplemental information to assist it in making registration decisions. After considering the comments it received, the Board adopted a final rule for registration of accounting firms on April 23, 2003, and the rule was approved by the SEC on July 16, 2003.

The rules, in keeping with the Act, require the registration of both U.S. and non-U.S. accounting firms that audit or play a substantial role in the audits of companies trading in U.S. markets. The Board was sensitive to the special concerns of foreign accounting firms and solicited a public roundtable discussion with non-U.S. government representatives and other interested persons on March 31, 2003. As a result, the Board provided certain accommodations in the registration process for foreign firms, including giving those firms additional time to register, ultimately setting the deadline for July 19, 2004.

> [I]t shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.
>
> —Title I, Sec. 102(a), Sarbanes-Oxley Act of 2002

Building the Registration System

Because of the importance of registration to the Board's oversight responsibilities, the Board chose to build the registration system and not outsource the registration function.

The Board recruited a team of experienced information-technology specialists who, working with the Board's registration and inspections staff, designed the Web-based system that would capture the information required from registration applicants while both protecting the confidentiality of the information and giving the Board's staff the ability to efficiently examine and analyze the information.

Work on the system began early in 2003, and it was ready for launch the day after the SEC approved the Board's registration rules.

The Board began accepting applications and fees in early August 2003 and made the names of applicants available to the public through its Web site beginning August 27. The Act and the Board's rules give the Board a 45-day period to review each application, after which the Board is required to approve the application, provide the applicant with a notice of a hearing to determine whether the application should be approved or disapproved, or request more information from the applicant, triggering another 45-day review period.

The Act compelled the Public Company Accounting Oversight Board to construct an unprecedented registry of domestic and non-U.S. accounting firms that audit, or play a substantial role in the audits of, public companies and mutual funds.

Evaluating Applications

In early September, the Board began considering applications. The Board reviewed, among other things, legal and disciplinary proceedings against the applicant firms, the firms' descriptions of their quality-control policies, the number and nature of audit clients, staffing levels, and any reported disagreements with clients. The decision on each applicant was based on a single consideration: is registration of this accounting firm consistent with the Board's responsibilities to protect investors and to further the public interest in the preparation of informative, fair and independent audit reports?

By the statutory deadline of October 22, the Board had answered the question affirmatively for 598 public accounting firms, including the four largest U.S. firms. The Board made the names of the registered firms available to the public through its Web site to enable public companies and mutual funds to confirm that their auditors were registered as required by law. The applications will be made public after requests for confidential treatment of certain information in the applications are evaluated.

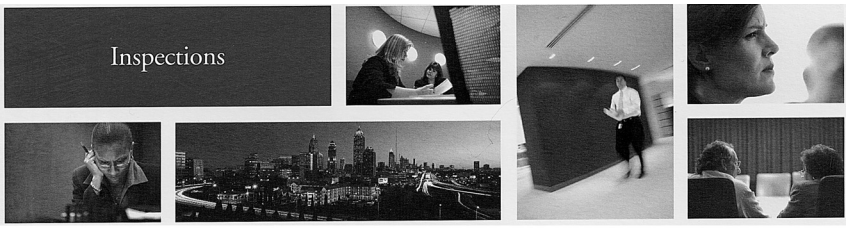
Registration applications continued to be filed after October 22, and the Board and staff continued the process of reviewing and considering the applications. By December 31, 735 firms were registered with the PCAOB.

The Board's rules also provide for hearings on registration applications. If the Board is unable to determine that a public accounting firm's application has met the standard for approval, the Board may provide the firm with a notice of a hearing, which the firm may elect to treat as a written notice of disapproval that can be appealed directly to the Securities and Exchange Commission. Alternatively, a firm may request a hearing by the Board.

Registered Firms by Number of Clients

Number of issuer clients	Fee for registration	Number of firms registered in 2003
0	$ 250	141
1–49	$ 500	579
50–100	$ 3,000	7
101–1,000	$ 29,000	4
1,001+	$390,000	4

The Board's rules also set out procedures for firms to withdraw from registration. Withdrawal is not automatic. The Board may order that withdrawal be delayed, for up to 18 months, while the Board carries out a relevant inspection, investigation, or disciplinary proceeding.



The inspection of registered accounting firms carries the potential for real-time improvement in the audits of public companies and will require the largest commitment of the Board's human and monetary resources.

This powerful tool gives the Board access to critical information relating to audit quality, ranging from competence and methodology to judgment and integrity. Inspections will provide insight into the registered firms' audit practices to see how firms implement applicable auditing and related professional practice standards, how they comply with applicable laws and rules, where they are doing well, and where improvements are needed. The inspection process will allow the Board to assess all of these things and, when necessary, to apply pressure to improve a firm's audit practices.

The Sarbanes-Oxley Act requires the Board to conduct annual inspections of registered accounting firms that audit more than 100 public companies. Eight such firms were registered with the PCAOB as of December 31. Other firms that audit, or play a substantial role in the audit of, any public companies are required to be inspected at least once every three years. The Board also has the authority to conduct special inspections as is necessary or appropriate to address issues that come to the Board's attention.

At the end of each inspection, the Board will issue a report of its findings, including criticisms of, and descriptions of potential defects in, the firm's quality control systems. The Act requires the Board to keep nonpublic any criticisms and potential defects unless the firm fails to correct them within 12 months.

The Board proposed its rules for inspections at a public meeting on July 28, 2003. After considering public comment, the Board adopted the inspection rules on October 7, 2003. The rules create a procedural framework for the conduct of the Board's inspection program.

The Board also determined that conducting limited inspections of the four largest firms would provide an important foundation for the full-scale inspections to come. Accordingly, the Board developed inspection procedures and conducted initial limited inspections of the four largest public accounting firms in the United States with the firms' consent.

These initial limited inspections focused on areas that have not been the traditional focus of the auditing profession's own peer review process, including "tone at the top" and partner evaluation, compensation, and promotion. The Board's inspectors also looked at how these firms performed selected audit engagements. The limited inspection procedures carved the path for the Board's comprehensive inspections program, which the Board will fully launch in 2004.

The fieldwork for the 2004 inspections will be conducted from approximately May to November 2004. In connection with these inspections, the Board will focus on, among other things, efforts to detect fraud, the adequacy of documentation, the evaluation of firm risk assessments, and compliance with professional standards. The Board also expects to continue its focus on

> The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.
>
> —Title I, Sec. 104(a), Sarbanes-Oxley Act of 2002

"tone at the top," compensation practices, and other business practices that were the subject of limited procedures in 2003.

To help carry out its inspection program, the Board opened an office in New York in September 2003 and began hiring staff for additional offices near Atlanta, Dallas, and San Francisco. The Board recruited a cadre of experienced public company auditors to conduct the inspections, and by year's end, the PCAOB inspection staff had grown to 60. The Board expects to more than double its inspection staff by the end of 2004 in order to carry out its statutory mandate.

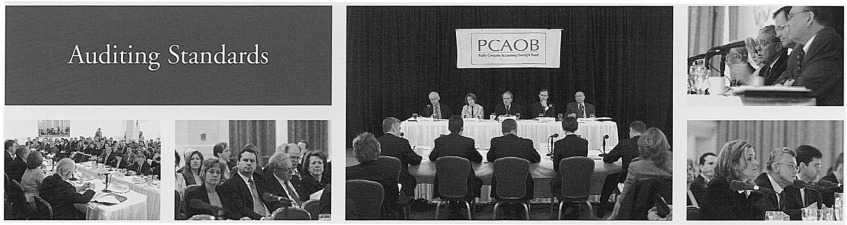
The Board's inspection teams are composed of accountants, who have an average of 12 years of auditing experience. Each team is led by an Associate Director or a Deputy Director of the Board's Division of Registration and Inspections, who are generally former partner-level employees of the major accounting firms and have an average of 22 years of auditing experience. The Board's ability to implement meaningful and robust inspections is a direct reflection of its inspections teams' high caliber, experience, and commitment.

The Board's statutory responsibilities extend to non-U.S. accounting firms that perform audit services for U.S. public companies or for non-U.S. issuers who are registered, and file reports, with the SEC. Accordingly, the Board's inspection program will encompass firms outside of the United States. As a result of a dialogue with its foreign counterparts and as part of a cooperative approach to the oversight of non-U.S. registered firms, the Board proposed a rule that would permit the Board to rely on the work of oversight systems in other jurisdictions, to an appropriate degree, on a case-by-case basis. In 2004, the Board will continue its dialogue with regulators in other countries in order to develop work programs for the inspections of non-U.S. firms.

Number of Issuers per Registered Firm

Registered firms (2003)	Issuer clients
8	100 or more
5	51–100
22	26–50
60	11–25
77	6–10
563	5 or fewer

Initial limited inspections focused on areas that have not been the traditional focus of the auditing profession's own peer review process, including "tone at the top" and partner evaluation, compensation, and promotion.



The Sarbanes-Oxley Act gives the Public Company Accounting Oversight Board considerable leeway in the design and adoption of standards for audits and professional conduct by auditors. Among other things, it authorizes, but does not require, the Board to designate a professional group of accountants to propose standards to the Board.

Early in 2003, the Board determined that it could best fulfill its mandate for the protection of investors by developing standards itself, with the assistance of a staff of highly qualified accountants recruited from academia, professional practice, and government.

As a result of the Board's decision, for the first time, the individuals developing auditing standards will have access to robust empirical and anecdotal evidence from the Board's inspections and enforcement activities—evidence that will cut through a cross-section of audits and firms—to assist in setting priorities and developing new standards.

The Act and the Board's rules require registered public accounting firms to adhere to the Board's auditing (and related attestation), quality control, and ethics standards, as well as its independence rules. Any registered accounting firm that fails to adhere to applicable standards may be subject to Board discipline.

New auditing standards will be established—and existing standards will be changed—only by Board rulemaking. While the Board will consider proposed new or amended auditing standards recommended to it by others, no such proposed rule will become a standard of the Board unless adopted by the Board through rulemaking.

The Board will also rely on advice from a standing advisory group to assist it in performing its standards-setting responsibilities. The Board also intends to solicit public comment, and, where appropriate, to convene hearings or roundtable meetings in order to obtain the views of issuers, accountants, investors, and other interested persons with respect to proposed auditing standards. In this regard, the Board welcomes input and advice from established professional bodies and includes practicing accountants among the members of its advisory groups.

Interim Auditing Standards

On April 16, 2003, the Board adopted certain existing standards as its interim auditing standards. Most of these standards were promulgated by the American Institute of Certified Public Accountants and pre-date the Board's formation. These interim standards are incorporated into the Board's rules. Registered public accounting firms are subject to the same obligation to comply with the interim standards while they are in effect as with permanent standards adopted by the Board.

> The Board shall, by rule, establish…such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.
>
> —Title I, Sec. 103(a), Sarbanes-Oxley Act of 2002

Despite the need to adopt these existing standards in order to assure continuity and certainty in the standards that govern audits of public companies, the Board has not determined whether it would be appropriate to include any of the interim auditing standards as permanent Board standards.

The Board will be mindful of the need to adopt new auditing standards, especially in response to emerging issues and problems that arise in connection with audits of issuers.

Audits of Internal Control over Financial Reporting
In 2003, the Board also set out to fulfill other provisions of the Act that require the Board to adopt standards in specific areas. The most complex of the required auditing standards related to an auditor's responsibility in regard to a public company's internal control over financial reporting.

For the first time, the individuals developing auditing standards will have access to robust empirical and anecdotal evidence from the Board's inspections and enforcement activities—evidence that will cut through a cross-section of audits and firms—to assist in setting priorities and developing new standards.

The Sarbanes-Oxley Act, in Section 404, requires company management to assess and report on the company's internal control over financial reporting. It also requires a company's independent, outside auditors to issue an "attestation" to management's assessment—in other words, to provide shareholders and the public at large with an independent reason to rely on management's description of the company's internal control over financial reporting.

The Board convened a public roundtable discussion on July 29, 2003, to discuss issues and hear views related to reporting on internal control. The participants included representatives from public companies, accounting firms, investor groups, and regulatory organizations.

After considering comments made at the roundtable, advice from the Board's staff, and other input, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."

The Board received 194 comment letters from a variety of interested parties, including auditors, investors, internal auditors, issuers, regulators, and others on a broad array of topics.

The final standard for audits of internal control, adopted by the Board on March 9, 2004, incorporated certain suggested changes and reflected certain basic principles on which the Board members agreed:

- Audit quality would be best improved by integrating the auditor's examination of internal control into the audit of a company's financial statements.
- The costs of an audit of internal control must be reasonable, particularly for small and medium-sized companies.
- Outside auditors may rely on the work of internal auditors and others, based on their competency and objectivity.
- An assessment of the effectiveness of a company's audit committee is a vital part of an audit of internal control and consistent with existing standards.

Audit Documentation
The Act directs the Board to adopt a standard requiring registered public accounting firms to prepare, and maintain for a period of not less than seven years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report.

The Board sought expert advice on the standard from auditors, regulators, investors, and issuers during a roundtable discussion on September 29, 2003, and proposed its standard for audit documentation on November 12, 2003.

The standard will be one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest. The integrity of the audit depends in large part on the existence of a

Auditing Standards
(CONTINUED)

complete and understandable record of the work that the auditor performed, of the conclusions that the auditor reached, and of the evidence that supports those conclusions. Meaningful review by a second partner, or by the Board in the context of its inspections, would be difficult or impossible without adequate documentation. Clear and comprehensive audit documentation is essential in order to enhance the quality of the audit and for the Board to fulfill its mandate to inspect registered public accounting firms "to assess the degree of compliance" of those firms with applicable standards and laws.

The standard would establish general requirements for documentation that the auditor should prepare and retain in connection with issuing an audit report on the financial statements of a public company. The standard would also set a new requirement that audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the work that was performed, who performed it, when it was completed, and the conclusions reached.

> The standard for audit documentation will be one of the fundamental building blocks on which both the integrity of audits and the Board's oversight will rest.

Auditing Standard No. 1—
References to PCAOB Standards

On December 17, 2003, the Board adopted Auditing Standard No. 1, requiring registered public accounting firms to include in their reports on the financial statements of public companies a statement that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)." The standard supersedes previous standards that required references to "generally accepted auditing standards," "U.S. generally accepted auditing standards," "auditing standards generally accepted in the United States of America," and "standards established by the AICPA." The standard was approved by the Securities and Exchange Commission on May 14, 2004, and became effective on May 24, 2004.

Advisory Groups and Task Forces

The Act provides that the Board shall "convene, or authorize its staff to convene, such expert advisory groups as may be appropriate… to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section."

On June 30, 2003, the Board adopted a rule describing its intention to convene a standing advisory group to participate in the standards-setting process. The advisory group will assist the Board in reviewing existing auditing standards, in formulating new or amended standards, and in evaluating proposed standards suggested by other persons. The Board may, based on the circumstances of particular projects, form *ad hoc* task forces composed of smaller groups of members of the advisory group, of the Board's staff, and other persons.

The Board began soliciting nominees for membership in the standing advisory group in November 2003 and received more than 170 nominations. The Board named the members of the standing advisory group in April 2004—30 individuals with a variety of perspectives, including practicing auditors, preparers of financial statements, the investor community, academia, and others.

Each member of the advisory group has expertise in at least one of the following areas: public company accounting; public company auditing; public company finance; public company governance; investing in public companies; or other disciplines that the Board deems to be relevant.

The members of the advisory group will serve in their individual capacities and may not delegate their duties as advisory group members, including attendance at meetings. Advisory group members are also subject to certain provisions of the Board's Ethics Code, including provisions designed to protect nonpublic information and avoid conflicts of interest.

The standing advisory group comprises 30 individuals with a variety of perspectives, including practicing auditors, preparers of financial statements, the investor community, academia, and others.

The European Commission recently proposed that financial statement audits in the European Union should be conducted in accordance with International Standards on Auditing, as developed by the International Auditing and Assurance Standards Board (the IAASB) and to the extent endorsed by the European Commission. In 2003, the Board accepted an invitation to observe, with speaking rights, the meetings of the IAASB. Similarly, the Board invited the IAASB to participate as observers in the standing advisory group. Although not an explicit objective of the Board, the Board supports the development of high-quality international professional standards.

Future Standards-Setting

While the Board has made significant strides its first year in crafting a process for setting standards in the public interest and in proposing and adopting certain of those standards, it still faces a challenging future agenda. Among the issues that the Board, its staff, and the standing advisory group expect to discuss in the coming year are:

- Reviews of existing, interim standards;
- Revision to the hierarchy for generally accepted auditing standards—to incorporate PCAOB auditing and related professional practice standards;
- Concurring or second partner review—to ensure all public company audits include a review by a second partner, and
- Communications and relations with audit committees—to incorporate requirements mandated under the Sarbanes-Oxley Act into the audit and related professional practice standards.

In addition, the Board is considering projects related to the quality control and independence standards, which Congress specifically addressed in the Sarbanes-Oxley Act.

The ability to impose disciplinary measures on errant accounting firms and auditors is one of the strongest tools given to the Board for the protection of investors. The Board is empowered to impose penalties as harsh as revocation of a firm's registration—effectively barring the firm from auditing publicly traded companies—and monetary penalties of as much as $15 million per offense.

In September 2003, the Board laid the groundwork for its enforcement program by adopting detailed rules to govern its investigative and disciplinary processes and to provide fair procedures for the conduct of investigations, the conduct of hearings, and the imposition and termination of sanctions. The rules were approved by the Securities and Exchange Commission on May 14, 2004.

The overall objective of the Board's enforcement program is to promote improvements in the quality of public company auditing by taking remedial and disciplinary measures with respect to—or, where appropriate, barring—registered accounting firms and associated persons that have failed to comply with the Sarbanes-Oxley Act, the rules of the Board, and the rules of the Securities and Exchange Commission relating to the preparation and issuance of audit reports or professional standards.

When a violation of those rules or standards is confirmed, the Board will impose sanctions intended to prevent a repetition of the violation and to enhance the quality and reliability of future audits.

The Board will implement its enforcement program with an emphasis on three important criteria:

- *Speed.* The Board believes it is important that it promptly and efficiently investigate significant instances of apparent audit failure. Prompt investigation will help shore up investor confidence.
- *Fairness.* The Board is committed to the principle that persons charged with violations should have a full and fair opportunity to present relevant evidence and arguments in their defense before any final determination is made.
- *Thoroughness.* Disciplinary proceedings should be based on a comprehensive assessment of the relevant facts.

> The Board shall establish…fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.
>
> —Title I, Sec. 105(a), Sarbanes-Oxley Act of 2002

The Act and the Board's rules require registered public accounting firms and their associated persons to cooperate with Board investigations. The Act and the Board's rules also permit the Board to seek information from other persons, including clients of registered firms and, should those persons not comply, to seek issuance of a Securities and Exchange Commission subpoena for the information.

As part of the cooperative approach to the oversight of non-U.S. accounting firms, the Board has proposed a rule that would allow the Board, under certain circumstances, to rely on the investigation or a sanction of a non-U.S. oversight authority.

Financial Review

Public Company Accounting Oversight Board

Year Ended December 31, 2003

The year 2003 was the initial operating year for the Public Company Accounting Oversight Board. The financial statements reflect significant investments in technology and hiring necessary for the Board to implement its mission to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

Each year, the PCAOB develops an operating budget that must be approved by the Securities and Exchange Commission, as required by the Sarbanes-Oxley Act of 2002. On April 23, 2003, the Board adopted a 2003 budget of $68 million, which was approved by the SEC on August 1, 2003.

The Board's start-up expenses were covered by advances from the Department of the Treasury, as authorized by the Act. The advances, drawn over the first eight months of the year, totaled $20,342,000 and were repaid in full on September 22, 2003, from the proceeds of the 2003 accounting support fees.

OPERATING REVENUE

The Act provides that the Board be funded by accounting support fees assessed on issuers as defined in the Act. The Board adopted rules for the allocation, assessment, and collection of accounting support fees on April 16, 2003, and the rules were approved by the SEC on August 1, 2003.

The accounting support fees or "fees from issuers," as reflected in the financial statements, are equal to the Board's budget for the fiscal year in which they are set, less the amount of fees received from public accounting firms to cover the cost of processing and reviewing registration applications.

Under the Act and the Board's rules, the annual accounting support fees are based on the average monthly U.S. equity market capitalization of publicly traded companies, investment companies, and other equity issuers. However, issuers with average market capitalization of less than $25 million and investment companies with net asset values of less than $250 million are exempt from the fees.

The Board issued invoices to approximately 8,500 issuers beginning in early August 2003. The Board collected approximately $51 million in accounting support fees. Approximately 62 percent of the issuers received invoices for $1,000 or less, and the largest 1,000 issuers received invoices for about 87 percent of the total fees.

Combined, publicly traded companies contributed about 95 percent of the total fees paid, while open-end mutual funds provided about 4.7 percent, and other investment companies paid the remainder.

Another source of revenue is the registration of public accounting firms that audit public companies. This is reflected as "fees from registering accounting firms" in the financial statements. These amounts are not used to fund the Board's operations but to recover the costs of processing and reviewing the registration applications. During 2003, the PCAOB registered 735 public accounting firms. Each applicant paid a registration fee to the Board based on the number of issuers the firm audited in the preceding calendar year. The total amount collected from registration applicants in 2003 was approximately $2 million.

Assessment of Accounting Support Fees for 2003

Fee	Number of issuers
$100–500	4,244
$501–1,000	1,094
$1,001–5,000	1,911
$5,001–10,000	472
$10,001–50,000	536
$50,001–100,000	75
$100,001–500,000	80
$500,001–1,000,000	8
$1,000,001+	4
Total	**8,424**

Financial Review (continued)

Public Company Accounting Oversight Board

Year Ended December 31, 2003

STATEMENT OF FINANCIAL POSITION

The PCAOB financial statements have been prepared in accordance with U.S. generally accepted accounting principles and are presented pursuant to Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations* (SFAS No. 117). In accordance with SFAS No. 117, the net assets of the PCAOB are not subject to restrictions and therefore all have been classified as unrestricted in the financial statements. The PCAOB's unrestricted net assets primarily consist of its investments in technology and amounts to fund operations in the subsequent year prior to collection of that year's accounting support fees.

Cash and cash equivalents include demand deposits with financial institutions and short-term, highly liquid investments. The PCAOB utilizes a sweep service from a financial institution to invest daily in overnight repurchase agreements, typically in U.S. Treasury or Agency issues. Cash and cash equivalents also include approximately $300,000 of cash collected on behalf of the Financial Accounting Standards Board (FASB). A corresponding amount of approximately $300,000 is included in accounts payable and other liabilities for amounts due to the FASB. The Financial Accounting Foundation (FAF) designated the PCAOB as the collection agent for invoicing and collection of the 2003 FASB accounting support fees, as authorized by the Sarbanes-Oxley Act. In August 2003, the PCAOB issued invoices for accounting support fees of approximately $25 million on FASB's behalf. The PCAOB earned and was paid approximately $210,000 for acting as FASB's collection agent in 2003.

Accounts receivable of approximately $2.2 million are almost entirely related to outstanding accounting support fees. As of year end, $567,000 of these fees remained uncollected. Roughly $1.4 million of the accounts receivable balance represents amounts due from approximately 430 issuers of American Depositary Receipts that were assessed incorrect accounting support fees due to errors in the market capitalization figures used to calculate their fees. The PCAOB withdrew the initial invoices on August 27, 2003, and issued new invoices as part of the billing cycle for the 2004 accounting support fee. Because the fees originally assessed to the 430 issuers were higher than they should have been, the errors effectively reduced the PCAOB's 2003 anticipated revenue by approximately $15.5 million and had the effect of reducing the share of the accounting support fee billed to and collected from all other issuers subject to the fee by that amount.

During 2003, the PCAOB invested approximately $19.1 million in furniture and equipment, leasehold improvements, and information technology to build the infrastructure of the organization. The PCAOB established its headquarters in Washington, D.C., a regional office in New York City, and a Northern Virginia office for its information technology group.

The investment in information technology included the design, development, and implementation of two proprietary software systems in 2003. The PCAOB invested approximately $3.6 million to develop a Web-based system for the registration of public accounting firms. The PCAOB also invested approximately $1.9 million to develop a system to determine and calculate accounting support fees. For each proprietary system, the Board considered the costs and benefits of making or buying the system, taking into account the cost, technology, use, and security. In each instance, the Board found that the benefits of building the system in-house outweighed the benefits of utilizing an existing system.

Financial Review (continued)

Public Company Accounting Oversight Board

Year Ended December 31, 2003

OPERATING EXPENSES

Program Activities

The Sarbanes-Oxley Act gives the PCAOB four primary responsibilities to carry out its mission: registration, inspections, standards-setting, and enforcement. These responsibilities represent the program activities for the Board as reflected in the financial statements. Costs associated with these programs include salaries, benefits, and other direct operating expenses relating to the specific activity.

Supporting Activities

Supporting activities made up a significant percentage of the PCAOB's 2003 operating expenses as a result of the need to establish a corporate infrastructure to support the Board's program activities. The supporting activities include the offices of the Board members and their staffs, the General Counsel's Office, Public Affairs, Government Relations, Finance, Human Resources, and Administration. The majority of these offices were operational for the better part of the year. Also included in supporting activities are costs relating to information technology operating costs for system maintenance, network support, and depreciation of information technology equipment. At year end, the PCAOB had 118 full-time employees.

Statement of Financial Position

Public Company Accounting Oversight Board

December 31, 2003

Assets	
Cash and cash equivalents (Note 2)	$14,984,233
Accounts receivable, less allowance for doubtful accounts of $51,270	2,193,903
Prepaid expenses and other assets	635,420
Furniture and equipment, leasehold improvements and technology, net (Note 3)	16,430,878
Total Assets	$34,244,434
Liabilities and Net Assets	
Liabilities	
Accounts payable and other liabilities	$ 5,417,498
Deferred rent (Note 4)	3,028,134
Total Liabilities	8,445,632
Net Assets	
Unrestricted	25,798,802
Total Net Assets	25,798,802
Total Liabilities and Net Assets	$34,244,434

The accompanying notes are an integral part of these financial statements.

Statement of Activities

Public Company Accounting Oversight Board

Year Ended December 31, 2003

Changes in Unrestricted Net Assets	
Operating Revenue	
Fees from issuers (Note 2)	$52,851,530
Fees from registering accounting firms (Note 2)	2,038,500
Total operating revenue	54,890,030
Operating Expenses	
Program activities (Note 2)	
Inspections and enforcement	6,894,716
Registration	2,445,869
Standard setting	1,496,450
Supporting activities	
Management and administration	13,968,312
Information technology	4,619,068
Total operating expenses	29,424,415
Operating Income	25,465,615
Interest Income and Other	333,187
Increase in Unrestricted Net Assets	25,798,802
Unrestricted Net Assets, beginning of year	—
Unrestricted Net Assets, end of year	$25,798,802

The accompanying notes are an integral part of these financial statements.

Statement of Cash Flows

Public Company Accounting Oversight Board

Year Ended December 31, 2003

Cash Flows from Operating Activities	
Cash received from issuers	$ 50,895,673
Cash received from registering accounting firms	2,032,250
Interest income and other	333,187
Cash paid to suppliers and employees	(19,177,792)
Net cash provided by operating activities	34,083,318
Cash Flows from Investing Activities	
Purchases of furniture and equipment, leasehold improvements and technology	(19,099,085)
Cash Flows from Financing Activities	
Advances	20,342,000
Repayment of advances	(20,342,000)
Net cash provided by (used in) financing activities	—
Net Increase in Cash	14,984,233
Cash and Cash Equivalents, beginning of year	—
Cash and Cash Equivalents, end of year	$ 14,984,233
Reconciliation of Net Income to Net Cash Provided by Operating Activities:	
Increase in Unrestricted Net Assets	$ 25,798,802
Reconciliation Adjustments	
Depreciation and amortization	2,668,207
Provision for losses on accounts receivable	51,270
Increase in receivables from issuers and registering accounting firms	(2,245,173)
Increase in prepaid expenses	(635,420)
Increase in accounts payable, accrued expenses and employee benefit accruals	5,417,498
Increase in deferred rent	3,028,134
Net Cash Provided by Operating Activities	$ 34,083,318

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Public Company Accounting Oversight Board

Year Ended December 31, 2003

NOTE 1. NATURE OF ACTIVITIES

The Public Company Accounting Oversight Board (the "PCAOB") was established by the Sarbanes-Oxley Act of 2002 (the "Act") to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. The Act established the PCAOB as a private, nonprofit corporation.

The U.S. Securities and Exchange Commission (the "SEC") has oversight authority over the PCAOB. Among other things, the SEC has the capacity to appoint or remove, for cause, members of the PCAOB's Board, approve the PCAOB's budget and rules, and review appeals of aspects of adverse PCAOB inspection reports and disciplinary actions. In its oversight role, the SEC determined on April 25, 2003, that the PCAOB had the capacity to discharge its responsibilities and enforce compliance with the Act. The PCAOB's initial year of activity primarily focused on the recruitment of qualified professionals, registration of public accounting firms, initial limited inspections of the four largest public accounting firms, the establishment of standards for the auditing profession, and the development of infrastructure to support its ongoing activities. The accompanying financial statements present the activities from January 1, 2003.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Presentation. The financial statements have been prepared in accordance with U.S. generally accepted accounting principles and are presented pursuant to Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations* ("SFAS No. 117"). Under SFAS No. 117, the PCAOB is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. The net assets of the PCAOB are not subject to restrictions and therefore all have been classified as unrestricted in the accompanying statements. The PCAOB's unrestricted net assets primarily consist of its investments in technology and amounts to fund operations in the subsequent year prior to collection of that year's funding. Inspections and enforcement, registration, and standard setting are the program activities for the PCAOB. Costs associated with these program activities include salaries, benefits, and other direct operating expenses relating to the above activities. Indirect costs, such as occupancy, are not allocated to program activities, but are included in management and administration under supporting activities.

Program Activities of the PCAOB

- Inspections and Enforcement. The PCAOB conducts a continuing program of inspections of registered public accounting firms to assess their compliance with the Act, the rules of the PCAOB and the rules of the SEC and professional standards, in connection with the firms' performance of audits, issuance of audit reports, and related matters involving issuers, as defined in the Act. The Act grants the PCAOB broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms.
- Registration. In accordance with the Act, the PCAOB reviews registration applications and annual reports for public accounting firms that choose to register with the PCAOB. Under the Act and PCAOB rules, an accounting firm that is not registered with the PCAOB may not prepare or issue, or play a substantial role in the preparation or issuance of, any audit report with respect to any issuer.

Notes to the Financial Statements (continued)

Public Company Accounting Oversight Board

Year Ended December 31, 2003

- Standard Setting. The PCAOB establishes auditing, related attestation, quality control, independence, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports.

Use of Estimates. The preparation of financial statements in accordance with U.S generally accepted accounting principles requires management to make estimates and assumptions that may affect the reported amounts of assets, liabilities, revenues, and expenses, and the disclosure of contingent assets and liabilities. Accordingly, actual results could differ from these estimates.

Fees from Issuers. Fees from issuers, which are referred to as Accounting Support Fees in the Act, are amounts invoiced to certain issuers whose shares are publicly traded and to certain investment companies to fund the operating budget of the PCAOB for that year. Such fees are recognized as revenue in the budget year to which they relate. The amount of fees invoiced to individual entities is determined as prescribed in the Act and the Rules of the PCAOB. The PCAOB reports all fees from issuers as an increase in unrestricted net assets.

Fees from Registering Accounting Firms. Fees from registering accounting firms are amounts collected from each public accounting firm that applies for registration with the PCAOB to recover the costs of processing and reviewing registration applications. The PCAOB reports all fees from registering accounting firms as an increase in unrestricted net assets and are recognized as revenue in the budget year to which they relate.

Cash Held for Others under Agency Agreement. On behalf of the Financial Accounting Standards Board (the "FASB"), the Financial Accounting Foundation (the "FAF") designated the PCAOB as the collection agent for invoicing and collection of the 2003 FASB accounting support fees. The PCAOB earned and was paid $209,400 from FAF for acting as the collection agent in 2003, which is included in interest income and other in the accompanying statement of activities. Otherwise, the PCAOB recognizes no revenue or expense related to this relationship and maintains a separate bank account for all fees collected on behalf of the FASB. As of December 31, 2003, the PCAOB had $304,131 included in cash and cash equivalents related to the FASB. A corresponding $304,131 was included in accounts payable and other liabilities for amounts due to the FASB.

Cash and Cash Equivalents. The term cash and cash equivalents, as used in the accompanying financial statements, includes currency on hand, demand deposits with financial institutions, and short-term, highly liquid investments purchased with a maturity of three months or less. At times, the PCAOB's demand deposits with financial institutions exceed federally insured limits. However, the PCAOB has not experienced any losses in such accounts, and management believes the PCAOB is not exposed to any significant credit risk on these accounts.

Depreciation and Amortization. Furniture and equipment, leasehold improvements, and technology are stated at cost, less accumulated depreciation and amortization computed under the straight-line method over their useful lives. Furniture and equipment and technology are depreciated over their estimated useful lives of 3 to 5 years. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining term of the current office leases.

Income Taxes. The PCAOB is exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code. Therefore the accompanying financial statements include no provision for income taxes.

Notes to the Financial Statements (continued)

Public Company Accounting Oversight Board

Year Ended December 31, 2003

NOTE 3. FURNITURE AND EQUIPMENT, LEASEHOLD IMPROVEMENTS, AND TECHNOLOGY

These assets consist of the following at December 31, 2003:

Furniture and equipment	$ 2,570,573
Leasehold improvements	2,598,037
Technology	13,930,475
Total	19,099,085
Accumulated depreciation and amortization	(2,668,207)
	$16,430,878

NOTE 4. LEASE COMMITMENTS

In 2003, the PCAOB occupied office space in Washington, DC, New York City, and Sterling, Virginia, on leases that expire from 2006 to 2013. The leases include provisions for scheduled rent increases over the respective terms.

Rent is being charged to expense using the straight-line method over the respective lease terms. Rent under this method was $2,342,617 in 2003. Deferred rent expense amounted to approximately $3,028,134 as of December 31, 2003. Deferred rent is being amortized over the remaining lives of the operating leases.

Minimum rental commitments under the operating leases for the office space as of December 31 are as follows:

Year ending December 31,	
2004	$ 2,769,023
2005	2,812,385
2006	2,756,464
2007	2,300,821
2008	2,346,838
Thereafter	11,364,699
	$24,350,230

NOTE 5. RETIREMENT BENEFIT PLAN

The PCAOB has a defined contribution retirement plan which covers active employees. The PCAOB matches contributions in an amount equal to 100% up to 6% of the eligible compensation. The PCAOB's contributions become fully vested immediately. The PCAOB's contributions to the employees' accounts were $412,152 for 2003.

NOTE 6. 2003 ADVANCES FROM THE DEPARTMENT OF THE TREASURY

In accordance with the Act, the PCAOB was advanced funds to cover its start-up expenses from The Department of the Treasury totaling $20,342,000 during 2003. These advances were repaid on September 22, 2003.

Independent Auditors' Report

Public Company Accounting Oversight Board

To the Board of the Public Company Accounting Oversight Board
Washington, DC

We have audited the accompanying statement of financial position of the Public Company Accounting Oversight Board (the PCAOB) as of December 31, 2003, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of the PCAOB's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Public Company Accounting Oversight Board as of December 31, 2003, and the changes in its net assets and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Beers & Cutler PLLC

Washington, DC
March 18, 2004

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Study prepared by the staff of the House Financial Services Committee
Submitted for the record on July 7, 2004

Section 404 Compliance Costs Decrease as Revenues Decrease

Annual Revenue	# of domestic listed companies (FEI respondents)*	First-Year Costs (FEI survey)*
over $5 billion	61	$4.67 (in millions)
$1 billion to $5 billion	90	$1.83
$500 million to $1 billion	52	$1.04
$100 million to $500 million	58	$0.78
$25 million to $100 million	29	$0.74
Below $25 million	10	$0.28

Comparison of costs of compliance with other factors:

Average cost of compliance for FEI respondents	$1.9 (in millions)
Average amount that a Fortune 500 company will pay in auditor-related fees for internal controls**	$1.3
Average revenue for a Fortune 500 company	$14,930.0
Average salary of a Fortune 500 CEO in 2004***	$6.6

*Survey published by Financial Executives International in January of 2004.
**Wall Street Journal article entitled "Long and Short: Corporate Regulation Must Be Working" (June 16th, 2004)
***Salaries published in the May 10th, 2004 issue of Forbes magazine.