

KING & SPALDING LLP
CLIENT ALERT

**PCAOB ADDS NEW REGULATORY SCRUTINY
TO PUBLIC COMPANY AUDIT PROCESS**

June 28, 2004

To Our Friends and Clients:

One of the cornerstones of the Sarbanes-Oxley Act of 2002 was its creation of the Public Company Accounting Oversight Board (the "PCAOB" or "Board"). The PCAOB is a private, non-profit corporation charged with regulating public company audits and the accountants who perform them. Broadly speaking, the Board has four primary duties, all of which are subject to oversight by the Securities and Exchange Commission (the "SEC"): (i) registering all accounting firms that audit the financial statements of public companies; (ii) establishing audit standards; (iii) conducting inspections of registered audit firms; and (iv) investigating potential violations of the Board's rules or applicable securities laws and imposing sanctions where appropriate.

In recent weeks, the SEC formally approved the PCAOB's first two auditing standards along with the rules that will govern the Board's inspections, enforcement investigations, and disciplinary proceedings. In the midst of these approvals, the Board recently held its first-ever public conference called "The PCAOB Speaks," during which all five members of the Board participated with most of the Board's senior staff members in a full day of speeches and panels discussing the Board's mission, accomplishments to date, and priorities for the future. These discussions, coupled with other public announcements by the Board, reveal a potentially aggressive new regulator whose jurisdiction and authority should be understood by both auditors and their public company audit clients. A few of the more notable recent developments and revelations are summarized here:

- On May 14, 2004, the SEC approved PCAOB Audit Standard No. 1, entitled *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, which changed the standard language required in audit reports issued in connection with public company financial statements. Effective May 24, 2004, such reports must include a reference that the audit was performed in accordance with the standards of the PCAOB, replacing the previous reference to compliance with generally accepted auditing standards.
- Also on May 14, 2004, the SEC approved the PCAOB's rules for enforcement investigations and adjudications. These rules suggest a process similar in many respects to those in place at the SEC and self-regulatory organizations, but potential PCAOB sanctions against audit firms are much more severe. And although the PCAOB's formal jurisdiction extends only to registered audit firms and their personnel, the PCAOB is expected frequently to seek information on a "voluntary" basis from the firms' public company audit clients and, as authorized by Sarbanes-Oxley, to request the SEC to issue subpoenas to companies that refuse to cooperate "voluntarily." Coupled with the PCAOB's recent hiring of its

first Director of Investigations and Enforcement (a former prosecutor and SEC enforcement attorney), the SEC's approval of the Board's enforcement rules opens the door to a new type of regulatory enforcement activity that is likely to affect all major audit firms and many of their public company audit clients.

- On June 1, 2004, the SEC approved the PCAOB's rules for conducting inspections of registered audit firms. Among other notable provisions, these rules require registered audit firms to cooperate with the inspection staff and make clear that inspections can result in referrals to the Board's enforcement staff, to the SEC, or to appropriate state regulators. The rules also grant an inspected audit firm the opportunity to review and comment on the Board's draft inspection report before it becomes final.
- This year, the PCAOB began its regular inspection program, as mandated by Sarbanes-Oxley, under which it will inspect all registered audit firms with more than 100 public company clients at least once annually and all other firms at least once every three years. According to PCAOB officials, inspections of registered audit firms will routinely include an assessment of the accuracy of the financial statements that the firms' public company clients have filed with the SEC, and thus the staff will frequently contact those clients directly for information relating to the audits of their financial statements.
- In its inspections, the PCAOB will be looking at the national offices of big firms as well as the practice offices that conduct the audits. The national office inspections will have a "top down" focus on firm policies, procedures, and culture, whereas the practice office inspections will have a "bottom up" focus including a review of individual audit engagements. In the latter regard, the Board's stated goal is to review approximately 5% of the public company audit engagements of the "big four" firms, approximately 15% of the engagements of the next four biggest firms, and a much higher percentage of the engagements of smaller firms.
- On June 9, 2004, the PCAOB adopted Audit Standard No. 3, *Audit Documentation*, along with final rules relating to the Board's oversight of non-U.S. accounting firms that participate in audits of companies having securities that trade publicly in the U.S. Both of these PCAOB actions require approval by the SEC.
- On June 17, 2004, the Commission approved the PCAOB's Audit Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, the subject of a previous Client Alert (http://www.kslaw.com/library/clientalert/clientalert_3_10.asp). This audit standard sets forth the professional standards and related guidance for independent auditors in attesting to, and reporting on, management's assessment of the effectiveness of internal controls as required by Section 404 of Sarbanes-Oxley.
- The PCAOB budget for 2004 is \$103 million, funded predominantly through "accounting support fees" assessed against all public companies based on their market capitalization relative to the overall market. Of the approximately 8,800 public companies assessed, the largest 100 companies pay nearly half of the total fees collected, while those in the smallest one-third of the universe of public companies pay less than \$500 each.

- The PCAOB has thus far registered approximately 975 accounting firms (including over 150 non-U.S. firms). Only eight registered firms (including one non-U.S. firm) have more than 100 public company audit clients. The “big four” firms audit approximately 78% of all U.S. public companies, which together generate nearly 99% of all U.S. public company revenues. The Board has disapproved the registration application of only one firm, a small firm that, among other things, had been subject to two adverse peer reviews, had failed to correct the cited deficiencies, and had failed to disclose on its registration application that it was a respondent in a resulting AICPA disciplinary proceeding.

If you have any questions about the PCAOB or the topics discussed above, please call your primary contact partner at King & Spalding LLP or contact Russ Ryan in the firm’s Washington, D.C. office at (202) 661-7984 or rryan@kslaw.com.

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