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AMENDMENTS TO LIMIT	)	PCAOB Release No. 2007-009
BOARD RULE 4003's FIXED	)	October 16, 2007
PERIODIC INSPECTION	)	
REQUIREMENT TO FIRMS THAT	)	PCAOB Rulemaking
REGULARLY ISSUE	)	Docket Matter No. 24
AUDIT REPORTS	)	

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Summary: After public comment, the Public Company Accounting Oversight Board ("Board" or "PCAOB") is adopting amendments to Rule 4003(b) to eliminate the Board's self-imposed requirement that it regularly inspect each registered public accounting firm that plays a substantial role in the preparation or furnishing of an audit report but does not issue an audit report. The Board also is amending Rule 4003 to eliminate the Board's self-imposed requirement to conduct an inspection of any firm that has issued an audit report, even if the firm does not regularly issue audit reports. The amendments do not affect the Board's inspection cycles for larger firms or for firms that regularly issue audit reports, nor do the amendments limit the Board's discretion to inspect any registered firm at any time. The amendments will take effect upon approval by the Securities and Exchange Commission ("Commission").

Board

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Under the Sarbanes-Oxley Act of 2002 ("the Act") and PCAOB Rules, it is unlawful for any public accounting firm to issue, or to play a substantial role in the preparation or furnishing of, an audit report with respect to any issuer unless the firm is registered with the Board.<sup>1/</sup> The Act also requires the Board to conduct a continuing program of inspections of certain registered firms. The inspection

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<sup>1/</sup> See Section 102(a) of the Act and PCAOB Rule 2100. As used in the Act, the Board's rules, and this release, "audit report," "issuer," and "play a substantial role" are defined terms. See Sections 2(a)(4) and 2(a)(7) of the Act and PCAOB Rules 1001(a)(vi), 1001(i)(iii), and 1001(p)(ii).

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requirement, however, extends to a smaller scope of firms than does the registration requirement. Although the Act authorizes the Board to inspect any registered firm at any time, the Act requires inspection only of a registered firm that "regularly provides audit reports" for issuers.

Section 104(b)(1) of the Act specifies minimum frequencies with which the Board must conduct inspections of such firms. Section 104(b)(1)(B) of the Act provides that with respect to each registered firm that "regularly provides audit reports for 100 or fewer issuers," the Board shall conduct an inspection at least once every three years.<sup>2/</sup>

In 2003, the Board adopted PCAOB Rule 4003, "Frequency of Inspections." Consistent with Section 104(b)(1)(B) of the Act, Rule 4003(b) provides that certain registered firms will be inspected at least once every three years. In two distinct respects, however, Rule 4003(b)'s scope goes beyond the Act's requirement to inspect firms that "regularly provide" audit reports for issuers. First, Rule 4003(b) provides that the Board will inspect any registered firm that, while registered, issues an audit report with respect to an issuer, regardless of whether the firm "regularly" does so. Second, Rule 4003(b) provides for regular inspections of any registered firm that plays a substantial role in the preparation or furnishing of an audit report, even if the firm never issues an audit report with respect to an issuer.

The Board's experience in the first years of the inspection program has affected the Board's view on the appropriateness of a self-imposed requirement to devote Board resources to regular inspections of such firms. Registered public accounting firms currently number 1,807. Of those firms, there are 679 that have issued audit reports with respect to issuers in both of the two most recent calendar years, and 123 others that have issued such audit reports in one of the two most recent calendar years. The Board has determined that the focus of its regular inspection program should be squarely on such firms and that the Board's rules should not require regular diversion of resources to inspect firms that do not issue audit reports or firms that have not done so more recently than three years ago. This is consistent with the risk-based focus that the Board generally brings to bear in considering the most prudent allocation of its inspection resources.

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<sup>2/</sup> Section 104(b)(1)(A) of the Act and PCAOB Rule 4003(a) provide for annual inspections of registered firms that issue audit reports for more than 100 issuers. The requirements concerning inspections of such firms would be unaffected by the amendments that the Board is adopting.

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Accordingly, the Board proposed amendments to Rule 4003(b) to eliminate these two respects in which the Rule goes beyond the Act.<sup>3/</sup> The Board received three comment letters to its proposal to amend Rule 4003, all of which were supportive of the amendments and the Board's determination that the focus of its inspections program should be on firms that regularly provide audit reports for issuers.<sup>4/</sup> The Board is now adopting the amendments substantially as proposed, and as discussed below. The amendments do not diminish the Board's authority to inspect any registered firm at any time. Rather, the amendments more precisely align the rule and the Act regarding the universe of registered firms that the Board must inspect, while leaving to the Board's discretion whether and when to inspect other firms.

A. Leaving to the Board's Discretion When to Inspect Firms That Play a Substantial Role But Do Not Provide Audit Reports

As noted above, Rule 4003(b) has provided that the Board will conduct at least triennial inspections of registered firms that play a substantial role in the preparation or furnishing of an audit report, even if those firms do not issue audit reports with respect to issuers. Of firms registered as of June 30, 2007, 222 had indicated on their registration applications that they either expected to play a substantial role in the year in which they filed their application, or that they had played a substantial role that year or the previous year, without having issued, or expecting to issue, an audit report in that same period.<sup>5/</sup> As of June 30, 2007, 35 of those 222 firms had issued audit reports after becoming registered, but 187 of

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<sup>3/</sup> See Proposed Amendments to Limit Board Rule 4003's Fixed Periodic Inspection Requirement to Firms that Regularly Issue Audit Reports, PCAOB Release No. 2007-007 (May 24, 2007), available at [www.pcaobus.org/Rules/Docket\\_024](http://www.pcaobus.org/Rules/Docket_024).

<sup>4/</sup> See Letter from Deloitte Touche Tohmatsu (July 20, 2007), Letter from PricewaterhouseCoopers LLP (July 23, 2007), and Letter from the New York State Society of Certified Public Accountants (July 24, 2007), available at [www.pcaobus.org/Rules/Docket\\_024](http://www.pcaobus.org/Rules/Docket_024).

<sup>5/</sup> The Board has not systematically collected or compiled data to determine the extent, if any, to which the category of registered firms that play a substantial role without issuing audit reports now includes additional firms that first played a substantial role after the time period covered by the registration application.

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those firms (including 162 non-U.S. firms and 25 U.S. firms) remained in the category of "substantial role only" firms.<sup>6/</sup>

At this time, the Board believes that requiring itself regularly to inspect each such firm is not the best use of the Board's resources.<sup>7/</sup> The Board believes that, at present, it is better to direct those resources toward addressing the policies, practices, and procedures of the firms that are ultimately responsible for the audit report on the issuer's financial statements.

The Board is therefore revising Rule 4003(b) to eliminate the provision for fixed periodic inspections of "substantial role only" firms. The Board will continue to monitor whether Board resources should, in some instances, be directed toward inspections of "substantial role only" firms. For example, Board inspections of firms that have issued audit reports sometimes involve reviewing aspects of the audit that involve the work of a "substantial role only" firm. Information that comes to the Board in that way, as well as information that may come from other sources, could lead the Board to exercise its discretion to inspect a particular "substantial role only" firm. In addition, the Board will continue to monitor whether other developments suggest, at some future date, that all "substantial role only" firms should be subject to Board inspection with some specified minimum frequency.

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<sup>6/</sup> This Release uses the phrase "substantial role only" to identify the relevant category of firms and to emphasize the distinction between this category of firms (which play a substantial role but do not issue audit reports with respect to issuers) and the separate category of firms that play a substantial role in some audits, but separately perform other audits in which they issue the audit report for the issuer (for example, a non-U.S. firm that plays a substantial role in the audit of a U.S. issuer by auditing a foreign subsidiary, but that separately has a foreign private issuer audit client for which it regularly provides audit reports). Even as amended, Rule 4003 will continue to provide for regular periodic inspection of firms in the latter category by virtue of their regularly issuing audit reports. In any such inspection, the Board could review, among other things, the firm's work and its system of quality control in relation to audits in which the firm played a substantial role.

<sup>7/</sup> The Board has not yet inspected a "substantial role only" firm. The Board has deferred inspections of such firms in order to focus on inspecting firms that have issued audit reports.

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### B. Leaving to the Board's Discretion When to Inspect Firms that Provide Audit Reports Only Irregularly

Rule 4003(b) has included an inspection requirement that is triggered if "during any of the three prior calendar years," a registered firm "issued an audit report with respect to at least one . . . issuer." This requirement goes beyond the Act's requirements as well, in that it encompasses firms beyond those that "regularly provide" audit reports for issuers.

The Board believes that requiring itself regularly to inspect each such firm is not the best use of the Board's resources. Accordingly, the Board is adopting two additions to Rule 4003 that will more precisely align the Rule with the Act by giving meaning to the Act's "regularly provides" language. First, paragraph (e) will allow the Board to forego an otherwise required inspection of a firm if, in two consecutive years of the inspection cycle, and before the Board conducts an inspection in that cycle, the firm does not issue any audit reports. With this provision, the rule will operate as follows with respect to registered firms that issue audit reports for 100 or fewer issuers. If a firm issues an audit report in calendar year 1, the firm would, by operation of Rule 4003(b), be subject to regular inspection before the end of calendar year 4. If the firm issues no audit reports in calendar year 2 and issues no audit reports in calendar year 3, the requirement that the Board inspect the firm before the end of calendar year 4 would fall away by operation of Rule 4003(e).<sup>8/</sup> In terms of the Act's requirement, such a firm would be considered not to be regularly providing audit reports for issuers. The rule would not require the Board to inspect the firm unless and until the firm triggered the operation of Rule 4003(b) anew by issuing another audit report.

Second, the Board has added a provision to existing paragraph (b), and has included a provision in proposed paragraph (e), specifying that no inspection requirement is triggered solely on the basis of the firm consenting to an issuer's

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<sup>8/</sup> The example in the text is in terms of Rule 4003(b)'s requirement for at least one inspection by the end of the third succeeding calendar year. In December 2006, the Board adopted Rule 4003(d), which, pursuant to authority provided in Section 104(b)(2) of the Act, allows a longer period for the first and second inspections of some registered firms. See PCAOB Release No. 2006-008, Amendments to Board Rules Relating to Inspections (December 19, 2006). (The Board has submitted Rule 4003(d) for Commission approval and that submission is pending.) Paragraph (e) has been written so that it would apply whenever a firm, for two consecutive years in any inspection cycle of three or more years, does not issue an audit report.

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use of a previously issued audit report.<sup>9/</sup> The provision has been included in paragraph (b), so that no such consent would trigger a requirement that the firm be inspected. The provision also has been included in paragraph (e), so that no such consent would preclude the operation of paragraph (e) in circumstances where paragraph (e) would otherwise apply. Again, in terms of the Act's requirement, any firm whose conduct in the relevant time frame is limited to consenting to the use of previously issued audit reports will be considered not to be regularly providing audit reports.

In adopting the amendments, the Board is making two slight changes from the wording of the amendments as proposed. These are minor clarifying changes and do not reflect any substantive change. First, where the proposed amendment to Rule 4003(b) said that a firm that issued an audit report in any calendar year would be subject to at least one inspection "in the three succeeding calendar years," the amendment as adopted says "in the three-year period following such calendar year." Second, where the proposed new Rule 4003(e) referred to "any audit report that the firm had previously issued," the amendment as adopted clarifies what was intended by "previously" by saying instead "any audit report that the firm had issued prior to such calendar years."

### C. Conforming Amendments

The Board also proposed amendments to conform Rule 4003(d) to the amendments described above, and the Board is now adopting those amendments to Rule 4003(d). Rule 4003(d) extends the time period within which the Board must conduct the first and second inspections of firms that Rule 4003(b) requires the Board to inspect, and, as previously adopted, included specific reference to "substantial role only" firms. The Board is amending Rule 4003(d) to eliminate that reference and to incorporate the limitation described above concerning a firm's consent to use a previously issued audit report.

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<sup>9/</sup> A registered firm's act of consenting to an issuer's inclusion of a previously issued audit report in a new Commission filing previously has been treated as issuance of an audit report sufficient to trigger the existing Rule 4003(b) requirement that the Board conduct an inspection.

**RELEASE**

On the 16th day of October, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

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J. Gordon Seymour  
Secretary

October 16, 2007

APPENDIX –

Amendments to PCAOB Rules 4003



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**Appendix – Amendments to Rule 4003**

The Board is amending Section 4 of its rules by amending Rule 4003. The relevant portion of the rules, as amended, is set out below. Language added by the amendments is shown in bold italics. Language deleted by the amendments is struck through. Other text in Section 4, including notes to the Rules, remains unchanged and is indicated by " \* \* \* " in the text below. Rule 4003(d), included below, was adopted by the Board in December 2006 and has been submitted to, but not yet been approved by, the Commission.

**RULES OF THE BOARD**

\* \* \*

**SECTION 4. INSPECTIONS**

\* \* \*

**Rule 4003. Frequency of Inspections**

\* \* \*

(b) ~~At least once in every three calendar years, beginning with the three-year period following the calendar year in which its application for registration with the Board is approved, a registered public accounting firm that, during any of the three prior calendar years, issued an audit report~~ ***Any registered public accounting firm that, in any calendar year, issues an audit report, other than by consenting to an issuer's use of a previously issued audit report,*** with respect to at least one ***issuer***, but no more than 100 issuers, or that played a substantial role in the preparation or furnishing of an audit report with respect to at least one issuer, shall be subject to ***at least one*** a regular inspection ***in the three-year period following such calendar year.***

\* \* \*

(d) Notwithstanding paragraph (b) of this Rule, with respect to any registered public accounting firm that became registered in 2003 or 2004 –

(1) this Rule does not require the first inspection of the firm sooner than the fourth calendar year following the first calendar year in which the firm, while registered, issued an audit report ***other than by consenting to an issuer's use of a previously issued audit report*** or played a substantial role in the preparation or furnishing of an audit report; and



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(2) this Rule does not require the second inspection of the firm sooner than the fifth calendar year following the first calendar year in which the firm, while registered, issued an audit report ***other than by consenting to an issuer's use of a previously issued audit report*** ~~or played a substantial role in the preparation or furnishing of an audit report.~~

***(e) Notwithstanding any other provision of this Rule, if, in two consecutive calendar years, a registered public accounting firm issues no audit reports other than by consenting to an issuer's use of a previously issued audit report, the Board shall have the discretion to forego any inspection of that firm that would otherwise be required because of any audit report that the firm had issued prior to such calendar years.***