

August 24, 2010

The Honorable Barney Frank  
Chairman  
Committee on Financial Services  
United States House of Representatives  
Washington, DC 20515

The Honorable Spencer Bachus  
Ranking Member  
Committee on Financial Services  
United States House of Representatives  
Washington, DC 20515

Re: Transparency of PCAOB Disciplinary Hearings and Related Proceedings

Dear Chairman Frank and Ranking Member Bachus:

On behalf of the Public Company Accounting Oversight Board, I am writing to ask that Congress enact legislation amending the Sarbanes-Oxley Act of 2002 so that disciplinary proceedings initiated by the Board against accounting firms and individual auditors will be public, unless the Board orders otherwise.

#### Background

The Sarbanes-Oxley Act established the Board to oversee auditors whose reports are filed with the Securities and Exchange Commission in order to protect investors and further the public interest in the preparation of informative, fair, and independent audit reports on the financial statements of public companies.<sup>1</sup> The Act authorizes the Board to inspect accounting firms for compliance with PCAOB standards and SEC rules; to impose disciplinary sanctions; and to set auditing and related professional practice standards. As of August 12, 2010, 2,433 firms,

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010), extended the Board's authority to audits of SEC-registered securities brokers and dealers.

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including 924 non-U.S. firms from 87 countries, were registered with the Board and subject to its oversight.

Adjudicatory proceedings to determine whether an auditor or audit firm should be sanctioned for violating applicable rules or standards are an important component of the Board's oversight authority. However, unlike the disciplinary proceedings of other, comparable regulators, the Board's cases are nonpublic at least until they are appealed to the SEC. Specifically, Section 105(c)(2) of the Sarbanes-Oxley Act provides that hearings associated with PCAOB disciplinary proceedings "shall not be public, unless ordered by the Board for good cause shown, with the consent of the parties to such hearing."<sup>2</sup>

#### Board Disciplinary Proceedings

Decisions to commence disciplinary proceedings are not made lightly. The Board brings such proceedings only after a thorough, nonpublic investigation and full consideration of the views and arguments of the potential respondent.<sup>3</sup> These investigations typically entail extensive document production and on-the-record testimony. At the conclusion of the investigation, the Board's enforcement staff considers whether or not the evidence gathered warrants a recommendation to the Board for disciplinary proceedings. The firm or individuals involved have the opportunity to submit a "statement of position" in defense of their conduct for the Board's consideration. An order instituting proceedings can be issued only if the Board determines, by majority vote, that there is sufficient and reasonable cause to proceed to a hearing.

If the Board votes to institute a disciplinary proceeding, the auditor or audit firm (or both) that has been charged may choose to either settle the

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<sup>2</sup> Further, Section 105(d)(1)(C) provides that, in the event of an appeal to the Commission, the Board may not report the disciplinary sanctions it imposed unless and until the Commission decides to lift the statutory stay on imposition of the sanctions. Under Section 105(e), an application to the Commission for review of a Board sanction results in an automatic stay.

<sup>3</sup> PCAOB Rules 5000, et seq., govern investigations, disciplinary proceedings, and related matters. These rules are available at [http://pcaobus.org/Rules/PCAOBRules/Pages/Section\\_5.aspx#rule5000](http://pcaobus.org/Rules/PCAOBRules/Pages/Section_5.aspx#rule5000).

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case or litigate with the Board's enforcement staff. If the choice is litigation, the matter is assigned to the Board's hearing officer. After pre-trial proceedings, there is a hearing at which the PCAOB's enforcement staff must prove its case and the respondent may present its defense. Evidence is introduced, and witnesses testify. Once the hearing officer issues his decision, either party — the auditor or the PCAOB enforcement staff — may appeal to the Board. As in any appeal, the parties file briefs and may request oral argument. If the Board's decision is unfavorable to the auditor or firm, they may appeal again — this time to the Commission.

From the initiation of the PCAOB disciplinary proceeding through the Commission decision to let the sanctions commence, the entire proceeding takes place behind closed doors. In this respect, the Board's enforcement proceedings are unlike those of other, comparable regulators.

#### Reasons for Seeking Legislation

The nonpublic nature of Board disciplinary proceedings has serious adverse consequences for the investing public, audit committees, the auditing profession, the Board, and other interested parties, such as Congress.

First, the public is denied access to important information regarding PCAOB cases. During the course of the proceeding, investors, audit committees, and other interested parties are kept in the dark about a respondent's alleged misconduct — no matter how serious. Even after the Board has found sufficient cause to initiate formal proceedings and a disinterested hearing officer has found that the alleged violations occurred, the matter may still remain unknown to the public at least until the case is appealed to the Commission. As a result, investors are unaware that companies in which they may have invested are being audited by accountants who have been charged, even sanctioned, by the Board. For example, during the nonpublic proceedings regarding Gately & Associates, the firm issued 29 additional audit reports on public company financial statements between the commencement of the Board's proceeding and the public disclosure of the Board's charges, which did not occur

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until the Commission affirmed the Board's decision to expel the Gately firm from public company auditing.<sup>4</sup>

Second, respondents have an incentive to litigate Board cases, regardless of whether they believe they will ultimately prevail. Contesting the allegations rather than seeking a settlement allows respondents to continue with their public company audit practice without any disclosure to clients or investors of the Board's charges for as long as the litigation is ongoing. In the Gately & Associates matter, over two years elapsed between the filing of the Board's case and the public disclosure of the sanctions. During that time, the firm continued to pursue its public company audit practice.

Third, the incentive to litigate rather than settle has the effect of consuming considerable PCAOB resources — which could be deployed to investigate other potential audit failures.<sup>5</sup> For example, the litigation of three recent cases involving partners at major international accounting firms has required over 17,000 hours of the PCAOB enforcement staff's time.<sup>6</sup> Indeed, two of these cases are still pending, and more staff time will be required to complete the proceedings — while the public remains unaware even that proceedings have been instituted.<sup>7</sup>

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<sup>4</sup> In the Matter of the Application of Gately & Associates, LLC and James P. Gately, SEC Release No. 34-62656 (August 5, 2010). The number of opinions issued was obtained from Audit Analytics.

<sup>5</sup> Because PCAOB Orders Instituting Proceedings are nonpublic, the potential issuance of such orders typically does not result in the commencement of settlement negotiations. In major cases, such negotiations generally occur closer to the trial date, which results in the PCAOB enforcement staff having to prepare for trial even in cases that eventually will settle.

<sup>6</sup> The more than 17,000 hours dedicated to the litigation of these matters does not include the substantial time the PCAOB enforcement staff devoted to the investigation of the conduct leading to the recommendation to institute disciplinary proceedings.

<sup>7</sup> One of these three cases was eventually settled prior to the administrative trial. That case resulted in the Board sanctioning two CPAs. See, *In the Matter of Jennifer Nakao, CPA*, PCAOB Release No. 105-2010-002 (Feb.

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Fourth, the public – including the Congress – cannot evaluate the Board's enforcement program. During the course of a PCAOB disciplinary proceeding no investor, no other auditor, no audit committee, no member of the media is entitled to know what conduct the Board considers to merit discipline, whom the Board has charged, what issues are being litigated, and whether the Board's enforcement staff has won or lost. As a result, the public is uninformed about the level of activity in the Board's enforcement program and how the Board uses its enforcement resources.

Finally, the nonpublic nature of the contested disciplinary proceedings limits the Board's ability to use enforcement authority as a tool to improve audit quality and deter violations of the Board's rules. When the Board concludes that there has been an audit failure that warrants enforcement action, the audit profession does not learn of that decision for an extended time period. Thus, other auditors who face similar situations will not be aware of what conduct prompted the Board to take disciplinary action or the potential severity of sanctions that might result from a violation.

#### Contrast to SEC Proceedings

The nonpublic nature of Board disciplinary proceedings is in sharp contrast to similar SEC administrative proceedings against auditors.

If the SEC were to bring the same case as the PCAOB, alleging the same violations, against the same auditor, the SEC's charges would be disclosed at the time the Commission instituted its proceeding. Any administrative trial would be open to the public. If there were an appeal to the Commission and an oral argument, the public could attend. The ability — or inability — of the Commission's staff to prove its charges would be a matter of public record.

In the 1980s, the Commission faced the same problem as now confronts the Board. SEC disciplinary hearings involving accountants and auditors were private until 1988 when the Commission amended its rules to make the hearings

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17, 2010) and *In the Matter of Ray O Westergard, CPA*, PCAOB Release No. 105-2010-003 (Feb. 17, 2010).



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presumptively public.<sup>8</sup> The reasons cited by the Commission for the change included:

- Virtually all other administrative proceedings brought by the SEC (including those against brokers, dealers, investment advisers, and public companies) and all SEC injunctive actions are public,
- Private proceedings create incentives for delays,
- The public and audit professionals are interested in timely disclosure of the standards used to commence disciplinary proceedings (the public and other auditors have a legitimate interest in learning, on a timely basis, the facts and circumstances that have led to the institution of proceedings), and
- Public proceedings are more favored in the law than closed-door proceedings.

These same reasons support the need for public PCAOB disciplinary proceedings. The Board, however, unlike the SEC, lacks the authority to make its proceedings public through a change to its rules.

### Legislative Proposal

The Board, therefore, respectfully requests that Congress enact legislation amending the Sarbanes-Oxley Act so that Board disciplinary proceedings will be open to the public, unless the Board orders otherwise in a particular case. Attached to this letter is draft legislative language that would accomplish that goal by amending Sections 105(c)(2) and 105(d)(1)(C) of the Act. If enacted, this proposed language would:

- Maintain the existing requirements regarding confidentiality of PCAOB inspections and investigations,

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<sup>8</sup> SEC Release No. 34-25893 (July 7, 1988); 53 FR 26427 (July 13, 1988).

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- Make Board disciplinary proceedings public, when the Board decides that the evidence gathered in an investigation warrants charging a firm or individual with violations, and
- Retain flexibility for the Board to order non-public proceedings in appropriate cases.

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We appreciate your consideration of this issue. The Board and its staff would be pleased to answer any questions and to provide any requested technical assistance.

Sincerely,



Daniel L. Goelzer  
Acting Chairman

Attachment

cc: The Honorable Paul E. Kanjorski  
The Honorable Scott Garrett

Similar letters sent to:

The Honorable Christopher J. Dodd  
The Honorable Richard L. Shelby  
The Honorable Jack Reed  
The Honorable Jim Bunning

**ATTACHMENT**

**SEC. XXXX. PUBLIC PROCEEDINGS**

Section 105 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7215) is amended –

(1) by amending subsection (c)(2) to read as follows:

“(2) PUBLIC HEARINGS.— Hearings under this section shall be public unless the Board, on its own motion or after considering the motion of a party, orders otherwise.”

(2) by amending subsection (d)(1)(C) to strike “(once any stay on the imposition of such sanction has been lifted)”.