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# Memorandum of understanding ("MOU") April 12, 2002

American Institute of Certified Public Accountants. SEC Practice Section. Transition Oversight Staff

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April 12, 2002

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Gentlemen:

Enclosed is a memorandum of understanding ("MOU") covering the responsibility of the Transition Oversight Staff ("TOS") for (a) the oversight of the Section's self-regulatory programs; (b) the oversight of the Auditing Standards Board; and (c) conducting the reviews of the design, implementation and operating effectiveness of the independence systems and controls (the "Reviews") of the largest public accounting firms, under the oversight of the Independent Reporter, Donald J. Kirk.

The MOU is a record of the agreement of the TOS, the staff of the SEC, the SECPS, the AICPA, the largest public accounting firms and the Independent Reporter with respect to all matters included therein, particularly the responsibilities of the TOS and the SEC's access to the documents relating to the TOS's oversight of the peer review and QCIC programs and the Reviews of the independence systems and controls for the transition period beginning April 1, 2002. The TOS's budget for the twelve months ending March 31, 2003 is set forth as Exhibit B to the MOU and a budget covering the Reviews of the largest firms' independence systems and controls will be provided to those firms when planning for the Reviews is complete, but not later than May 15, 2002.

Sincerely,

Jerry D. Sullivan

Enclosure

April 12, 2002

**MEMORANDUM OF UNDERSTANDING (“MOU”)**

In January 2002, the members of the Public Oversight Board (the “POB”) announced their intention to terminate the existence of the POB. The Executive Committee (the “Executive Committee”) of the SEC Practice Section (the “Section”) of the American Institute of Certified Public Accountants (the “AICPA”) and the AICPA have determined that, notwithstanding the POB’s announcement, it is in the public interest for the Section to continue its self-regulatory activities, including the Peer Review Committee (“PRC”) and Quality Control Inquiry Committee (“QCIC”) programs and the activities of the SEC Regulations Committee and the Professional Issues Task Force (the “PITF”), until a new structure for regulating accountants and/or their firms that audit the financial statements of entities that file such statements under the federal securities law (“Public Auditing Firms”) is operational. The Section has concluded that oversight of the Section’s programs is essential and that the oversight activities that the staff of the POB conducted over the Section’s activities should continue until a new regulatory structure is in operation (the period commencing on April 1, 2002 and ending on the date that such regulatory structure is operational is referred to as the “Transition Period”). The AICPA has determined also that the oversight activities that the staff of the POB conducted over the activities of the Auditing Standards Board (“ASB”) should continue during the Transition Period. Finally, the largest Public Accounting Firms (the “Firms,” and each individually, “Firm”) have determined that reviews of the design and implementation and operating effectiveness (the “Reviews”) of the systems, procedures, and internal controls developed by the Firms for compliance with the independence rules of the SEC, the AICPA, the Independence Standards Board, and the Section (the “Systems and Controls”) should be conducted.

The purpose of this MOU is to describe the following agreements:

(1) The agreement of the Executive Committee, the AICPA, the staff of the Securities and Exchange Commission (the “SEC Staff”) and the staff of the former POB, which functions under the name “Transition Oversight Staff” as of April 1, 2002 (the “TOS”), relating to the TOS’s oversight of the Section and the SEC Staff’s access to documents relating to the TOS’s oversight of the peer review and QCIC programs;

(2) The agreement of the AICPA, the SEC Staff and the TOS, relating to the TOS’s oversight of the ASB; and

(3) The agreement of the Firms, the SEC Staff, the TOS and the Independent Reporter relating to the Reviews by the TOS of the Systems and Controls, the oversight and reporting on the TOS’s Reviews by the Independent Reporter and the SEC Staff’s access to documents relating to the Reviews.

## **I. The Responsibilities of The Transition Oversight Staff**

### **A. Background of Self-Regulation**

On September 17, 1977, the AICPA created the Section, which is designed to enhance the quality of the audit practice of Public Auditing Firms through, among other things, requiring peer reviews and the reporting of litigation to the QCIC. The AICPA created the POB to oversee

the activities of the Section to assure that the public interest in public auditing received appropriate consideration at all times.

On January 17, 2002, SEC Chairman Harvey Pitt announced that he believed that a new regulatory system should be developed to provide private sector regulation, rather than self-regulation, of the accounting profession. Shortly thereafter, the members of the POB announced their intention to terminate the existence of the POB by March 31, 2002. The SEC Staff, the Section, the AICPA, and the staff of the POB have agreed that the staff of the POB will continue its existence as the TOS for the Transition Period beginning April 1, 2002. The TOS will perform its oversight activities in accordance with this MOU.

#### B. Goal of Oversight

The TOS shall oversee the peer review, quality control, and other Section activities and the auditing standard-setting process, in order to represent the public interest on all matters that may affect public confidence in the integrity, reliability, and credibility of the audit process. In fulfilling its responsibilities, the TOS shall provide appropriate communication between itself and members of the public, the accounting profession, the AICPA Board, the ASB, the Congress, the SEC, other regulatory agencies at all levels of government, the Section, and its member firms.

#### C. Specific Oversight Responsibilities of the TOS

##### 1. Section

i. The TOS shall provide oversight with respect to the processes and activities conducted by and through the Section, including its Executive Committee, the PRC, the QCIC, the SEC Regulations Committee, and the PITF.

ii. The TOS shall oversee the activities of the Section's committees and task forces to assess and report on their effectiveness. The Executive Director of the TOS or his designee, as part of the TOS's oversight activities, may attend meetings of such committees and task forces to express views relating to its oversight responsibilities. The Executive Director of the TOS or his designee shall meet periodically with the Executive Committee.

iii. The TOS may recommend issues for inclusion on the agenda of the Executive Committee.

iv. The TOS shall report on its oversight activities in its annual report.

## 2. Auditing Standards Board

The TOS shall have oversight authority with respect to the ASB and its activities related to audits of the financial statements of SEC registrants. The oversight responsibility of the TOS is as follows:

- Representatives of the TOS, as part of the TOS's oversight activities, may attend meetings of the ASB and will have the opportunity to express their views, but such representatives shall have no right to vote on any ASB matters, including the ASB's work on auditing standards.
- The TOS shall evaluate the implementation of the ASB standards through the peer review process and advise the ASB concerning such evaluation.
- The TOS may recommend issues for inclusion on the agenda of the ASB.
- The TOS shall report on its oversight activities in its annual report.

### 3. Independence Reviews

i. The TOS has the responsibility for the Reviews of the Systems and Controls. The Firms have agreed with the SEC Staff that the Reviews should be conducted and reported on by the TOS.

ii. (a) For purposes of the Reviews, the Systems and Controls are considered to have the following elements:

- (1) Written independence policies and procedures;
- (2) Automated tracking system (if required by the Section's membership requirements) and restricted entity list;

- (3) Independence training;
- (4) Internal monitoring of independence Systems and Controls;
- (5) Senior management and others responsible for independence Systems and Controls;
- (6) “Tone at the Top” and culture relating to independence;
- (7) Prompt reporting of personnel employment negotiations;
- (8) Reporting by personnel of apparent independence violations;
- (9) Disciplinary policies; and
- (10) Independence quality controls of the Firms relating to foreign associated firms, as set forth in the Section’s membership requirements.

(b) Should a Firm being reviewed have an “alternative practice structure,” as referred to in Financial Reporting Release No. 56 (Nov. 21, 2000), the Systems and Controls related to that structure will be treated as a separate element to be included in the Reviews.

iii. The Reviews will be conducted in accordance with the work programs developed by the TOS.

iv. The Reviews will cover design and implementation of the Systems and Controls as of June 30, 2001 and their operating effectiveness during the six months ended December 31, 2001.



v. The standards governing the Reviews are the independence requirements of the SEC, AICPA, Independence Standards Board, and the Section, and the independence quality control provisions in the SEC's rules, Statement on Quality Control Standards No. 2, and the Section's membership requirements (particularly Appendices K and L, which cover *Foreign-Associated Firms* and *Independence Quality Controls*, respectively).

vi. The TOS will assign at least two senior TOS employees or consultants to each Review to perform tests of the design and implementation of the Systems and Controls.

vii. The TOS will engage independence experts, including experts from the reviewed Firm's peer reviewers, to perform tests of operating effectiveness pursuant to the TOS's work programs. The TOS will define, supervise, and assume responsibility for the work performed by the independence experts.

viii. The TOS will assign specific employees or consultants to each of the elements of the Systems and Controls to ensure consistency of approaches across the Firms to be reviewed as to sample sizes and testing procedures and the fairness of the evaluation of the specific elements of the Systems and Controls.

ix. The TOS will issue one report that will include a discussion of the following:

- A description of the scope, methodology, and work performed.
- A description of each Firm’s U.S. practice, including lines of business, and the approximate number of partners and professionals covered by the independence rules.
- A summary of each Firm’s Systems and Controls.
- A description of the findings and evaluation of whether the design, implementation, and operating effectiveness of the Systems and Controls of the Firms provide reasonable assurance of compliance with the independence rules.
- If a Firm’s Systems and Controls provide reasonable assurance that there was compliance with the independence rules, but there were deficiencies in their design, implementation, or operating effectiveness, then observations and recommendations concerning those deficiencies would be set forth in an appendix attached to the report. This appendix would also include any letter from the Firm in response to these observations and recommendations. Any observations and recommendations that are not included in the appendix but are considered significant enough to bring to the attention of the Firm’s senior management would be communicated in writing to the Firm, and not included in the report.
- Identification of any “best practices” observed during the Reviews.
- Any recommendations to the Section or other standard setters that are deemed warranted based on the results of the Reviews.

x. To assure the thoroughness of the Reviews and the completeness and fairness of the TOS’s public report, Donald J. Kirk, the former Vice Chairman of the POB and a former Chairman of the Financial Accounting Standards Board, will serve as the

Independent Reporter and oversee the TOS's activities in connection with the Reviews. The Independent Reporter will issue a report as to whether the process followed by the TOS in conducting the Reviews was properly designed and performed and whether the Reviews have been appropriately assessed and reported by the TOS.

xi. The reports of the TOS and the Independent Reporter are expected to be issued no later than October 31, 2002. The TOS and the Independent Reporter may seek an extension of time by making a written request to the SEC Staff.

xii. A confidentiality agreement, in the form attached as Exhibit A, and separate confidentiality letters, in the form set forth as Exhibit 1 to the confidentiality agreement, will be executed, as appropriate in accordance with the confidentiality agreement, by each person involved in the Reviews prior to the time that any such person obtains any Information, as that term is defined in the confidentiality agreement.

xiii. The TOS will maintain any appropriate work papers relating to the Reviews. No other person, with the exception of the Independent Reporter, will retain any documentation relating to the Reviews once the final public reports relating to the Reviews are issued.

#### 4. Implementation of Recommendations of the Panel on Audit Effectiveness

i. The TOS will monitor the activities of the Section, the ASB, auditing firms, the SEC, the AICPA, and the Financial Accounting Standards Board in response

to the recommendations made by the Panel on Audit Effectiveness in its report issued in August 1999.

ii. The TOS will issue a separate report that describes the Panel's recommendations and the steps taken by the affected parties to consider whether and, if so, how to implement the recommendations.

#### D. Operational Matters

##### 1. Issue an Annual Report

i. The TOS will issue a written annual report containing a description of its oversight activities with respect to the processes and activities conducted by and through the Section, including its Executive Committee, the PRC, the QCIC, the SEC Regulations Committee and the PITF, and its oversight activities in connection with the ASB.

ii. The report will also include, among other matters, the audited statement of expenses required in section I.D.4.iv.

##### 2. TOS Staff and Other Persons Involved in the TOS's Activities

i. The TOS will have permanent, full-time employees and others supervised by an Executive Director. The Executive Director will be Jerry D. Sullivan, unless

the SEC Staff, the Executive Committee, and the AICPA determine to replace him. If Jerry D. Sullivan is unable or unwilling to serve as the Executive Director of the TOS, his successor must be approved by the SEC Staff, the Executive Committee and the AICPA. The Executive Director will have the authority to hire and terminate the employees of and consultants, counsel, and advisors to the TOS and the independence experts, subject to the budgetary limitations in the budget agreed to by the Section and attached as Exhibit B.

ii. The TOS will maintain such books and records as the Executive Director determines to be necessary to evidence the oversight activities of the employees of and consultants to the TOS.

### 3. Indemnification and Advancement of Expenses

i. The AICPA has agreed, as reflected in the letter attached as Exhibit C, that Section 4.4 of its bylaws applies or will apply to each present and future employee of, consultant and advisor to, and independence expert and the Independent Reporter for the TOS (each an “Indemnified Party”) so that, to the full extent authorized by law for the good faith exercise of judgment in the performance of assigned duties, the AICPA will indemnify and advance related expenses to any person made or threatened to be made a party to any action, suit, investigation, inquiry, or proceeding, whether criminal, civil, or administrative, by reason of the fact that he or she, or her or his testator or intestate, is or was an employee of, consultant or advisor to, or independence expert or the Independent Reporter for the TOS. Within ten (10) days after receipt by an Indemnified Party of notice of the commencement or

threat of any action, suit, investigation, inquiry, or proceeding, such Indemnified Party will, if a claim in respect thereof is to be made against the AICPA under this section, notify the AICPA. The AICPA shall continue to indemnify the Indemnified Party for all costs and expenses incurred by such Indemnified Party until such time, if any, as the AICPA notifies the Indemnified Party that it will assume the defense of such commenced or threatened action, suit, investigation, inquiry, or proceeding. If the AICPA assumes such defense, it shall have the authority to settle any such action, suit, investigation, inquiry, or proceeding with the approval of the Indemnified Party, which approval shall not be unreasonably withheld.

ii. Without limiting the foregoing, the AICPA Board has advised the TOS in the letter attached to this MOU that the AICPA may contract for insurance against all or a portion of any liabilities and expenses resulting from the indemnification or advancement of expenses of any of the foregoing persons pursuant to this section or otherwise as permitted by law, and also may contract for companion insurance directly insuring any or all of such persons against liabilities and expenses.

iii. The foregoing right of indemnification and advancement of expenses will not affect any rights to indemnification and advancement of expenses to which any persons may be entitled by contract or otherwise under law.

#### 4. Funding of the TOS

i. The Section will provide the TOS with the financial resources to discharge its oversight responsibilities in accordance with this MOU. The Section will not fund

the Reviews of the Firms (which Reviews will be funded by the Firms themselves as set forth in section I.D.4.iii below).

ii. The budget attached as Exhibit B has been submitted by the TOS to the Section for the activities of the TOS agreed to in this MOU during the first year of the Transition Period. That budget does not cover the Reviews of the Systems and Controls of the Firms. (Budgets for those Reviews will be submitted to the Firms when planning for the Reviews is complete.) Should the Transition Period exceed one year, the TOS will submit another budget to the Section. In the event the expenses of the TOS are expected to materially exceed the attached budget, the TOS will immediately notify the Section and will explain why the budget will be exceeded. Notwithstanding the attached budget, the Executive Committee may agree to an increase in the budget based on the consideration of all the circumstances and public interest at any time during the year.

iii. Each Firm whose Systems and Controls will be reviewed by the TOS will pay the TOS for:

(a) Its equal share of the costs, fees and out-of-pocket expenses incurred by the TOS after March 31, 2002 in connection with planning for the Reviews.

(b) The costs of the TOS for retaining independence experts involved in the Review (see section I.C.3.vii.) at an hourly rate of \$450, plus their out-of-pocket expenses;

(c) The fees and out-of-pocket expenses that the TOS pays to its consultants in connection with the Review;

(d) The time worked on the Review by TOS employees at the same hourly rate that the TOS pays to its consultants (\$200), which payment will reduce the amount payable by the Section under the budget set forth in Exhibit B; and

(e) Its equal share of the payments by the TOS to the Independent Reporter (\$5,000 per month) and counsel, and out-of-pocket expenses for their activities related to the Reviews.

iv. In furtherance of its financial accountability, the TOS shall include in its annual report a statement of its expenses audited by an independent certified public accountant.

## **II. SEC ACCESS TO THE SECTION'S PROGRAMS**

The SEC Staff, the Section, and the TOS acknowledge that the SEC, the PRC, the Executive Committee, and the POB entered into a memorandum of understanding dated October 13, 1982 regarding the SEC's access to the POB's documentation related to the peer review program. The SEC Staff, the Section, and the TOS acknowledge that the SEC, the QCIC, the



Executive Committee, and the POB entered into an agreement dated September 12, 1995 relating to the SEC's access to QCIC documentation prepared exclusively for the use of the SEC. The SEC Staff, the Section, and the TOS agree that the SEC Staff shall continue to have access to the TOS's documentation relating to peer reviews and the QCIC program in a manner consistent with the aforementioned memorandum and agreement, as such memorandum and agreement are being implemented on the date of this MOU.

### **III. SEC ACCESS TO THE REVIEWS OF THE INDEPENDENCE SYSTEMS**

The SEC Staff, the Firms whose Systems and Controls are being reviewed by the TOS, and the Independent Reporter agree that the SEC Staff shall have access to the TOS's documentation relating to the Reviews to enable the SEC to make its own evaluation of the adequacy of the Reviews.

#### **A. The Access Agreement**

The following general principles underlie the agreement reached by the appropriate parties to this MOU and serve as a basis for defining the responsibilities assumed by each party and for determining procedures to be followed:

1. The SEC Staff will have access to all work papers of the TOS and the Independent Reporter.

2. The SEC Staff will not have access to any work papers until after the reports of the TOS and the Independent Reporter have been issued.

3. The SEC Staff will not retain or make copies of work papers of the TOS or the Independent Reporter.

4. The TOS and the Independent Reporter will not maintain any work papers that would allow identification of a Firm's clients or personnel, provided, however, that the TOS and the Independent Reporter are permitted to maintain in its and his work papers, respectively, the Firm's management organizational chart and a document that identifies the Firm personnel having oversight responsibility of the Systems and Controls.

B. Retention of Work Papers

In order to facilitate any review by the Firm's peer reviewer that might otherwise be feasible and appropriate, the TOS and the Independent Reporter will retain work papers relating to the Review for a period not to exceed one year after the issuance of the final public reports relating to the Review, or such shorter period as the TOS determines to be appropriate with the consent of the Independent Reporter and the SEC Staff, unless otherwise required by court order or other legal process and subject to the provisions of section A above.