

December 2002

SECURITIES AND  
EXCHANGE  
COMMISSION

Actions Needed to  
Improve Public  
Company Accounting  
Oversight Board  
Selection Process





Highlights of [GAO-03-339](#), a report to the Chairman, Senate Banking, Housing, and Urban Affairs Committee; Ranking Minority Member, House Energy and Commerce Committee; and another House requester

## Why GAO Did This Study

The Sarbanes-Oxley Act of 2002 created, among other things, the Public Company Accounting Oversight Board (PCAOB) to oversee audits of public companies. A divided Securities and Exchange Commission (SEC) appointed the first PCAOB on October 25, 2002. Amid allegations that the SEC Chairman withheld relevant information from the other Commissioners concerning the suitability of the newly appointed PCAOB chairman, GAO was asked to examine SEC's selection process; determine whether the SEC Chairman withheld information from other Commissioners; determine what vetting of candidates took place; and identify what actions led to breakdowns in the process.

## What GAO Recommends

GAO recommends that SEC define and reach agreement on a documented PCAOB appointment process; set selection criteria; develop a vetting process and complete necessary reviews before appointments; and make greater use of available technology to do background checks on candidates. While no written comments were provided, SEC generally agreed with the report's recommendations.

[www.gao.gov/cgi-bin/getrpt?GAO-03-339](http://www.gao.gov/cgi-bin/getrpt?GAO-03-339).

To view the full report, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

# SECURITIES AND EXCHANGE COMMISSION

## Actions Needed to Improve Public Company Accounting Oversight Board Selection Process

### What GAO Found

SEC faced significant challenges in vetting and appointing five members to the newly created PCAOB within 90 days. The SEC Chairman, who had overall responsibility for the appointment process, initially, envisioned a process primarily driven by SEC staff. He asked the Chief Accountant to take the lead in selecting and the General Counsel in vetting PCAOB members. However, this approach was not fully understood or endorsed by the other Commissioners. The overall process that emerged was neither consistent nor effective and changed and evolved over time.

Several factors contributed to the eventual breakdown of SEC's selection and vetting process, including the inability of the Commissioners to reach agreement on a formalized process that defined the roles to be played by the Commissioners and staff; insufficient communication between SEC staff and Commissioners; and the lack of articulated selection criteria beyond general criteria provided by the act. Finally, inability to choose a final slate of candidates until the eve of the Commission's vote resulted in the appointment of PCAOB members who had not been fully vetted.

On the day of the October 25 vote, the Chief Accountant became aware of information concerning Judge William Webster, who was slated to be the chairman of the PCAOB, and his role as the former chairman of the audit committee of a small company—U.S. Technologies, Inc. However, based on his review of available information, his experience as an auditor, Judge Webster's prominence and reputation, and the fact that additional vetting would occur post-appointment, the Chief Accountant deemed that the information would not affect Judge Webster's nomination. He thus decided not to share the information concerning Judge Webster's role at U.S. Technologies with the SEC Chairman, the other Commissioners, or the General Counsel.

As Judge Webster's appointment illustrates, the five individuals chosen for the PCAOB were not systematically vetted prior to appointment. After the selection process broke down in early October when the Commission was unable to agree on a consensus candidate for chairman, the General Counsel was forced to initiate the vetting process on a post-appointment basis, a fact which the Commission was made aware of before the October 25 vote. At the time of our review, the vetting process was still ongoing.

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## Abbreviations

CPA	Certified Public Accountant
CRM	Contract Resource Management, Inc.
EDGAR	Electronic Data Gathering and Retrieval System
FAF	Financial Accounting Foundation
FASB	Financial Accounting Standards Board
FBI	Federal Bureau of Investigations
NRSI	Name Relationship Search Index
PCAOB	Public Company Accounting Oversight Board
RFQ	Request for Quotations
SEC	Securities and Exchange Commission
TIAA-CREF	Teachers Insurance and Annuity Association – College Retirement Equities Fund



United States General Accounting Office  
Washington, DC 20548

December 19, 2002

The Honorable Paul S. Sarbanes  
Chairman, Committee on Banking,  
Housing, and Urban Affairs  
United States Senate

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Energy and Commerce  
House of Representatives

The Honorable Barney Frank  
House of Representatives

In response to the unexpected and rapid bankruptcies of large companies such as the Enron Corporation and WorldCom, Inc., concerns about the integrity and reliability of financial disclosures, and the adequacy of regulation and oversight of the accounting profession, the Sarbanes-Oxley Act of 2002 was enacted into law on July 30, 2002. A cornerstone of this reform was the creation of the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies. The PCAOB was given broad powers to inspect the accounting firms performing those audits, set rules and standards for such audits, and impose meaningful sanctions if warranted. The act required the Securities and Exchange Commission (SEC) to appoint members to this independent, full-time, five-member board by October 28, 2002, and to continue doing so as terms of office expired. On October 25, 2002, amid mounting controversy about who should be selected as chairman, a divided Commission appointed the first five PCAOB members.

On October 31, allegations emerged that the SEC Chairman had withheld relevant information from his fellow Commissioners concerning the newly appointed PCAOB chairman's, Judge William H. Webster, involvement as the former chairman of the audit committee of the board of directors of U.S. Technologies, Inc., a small company. In response to these allegations, you asked that we thoroughly examine the process SEC used to select and vet nominees to the PCAOB. Our specific objectives were to (1) describe the process and significant events leading up to the Commission's selection of the PCAOB's first members, (2) determine what the SEC Chairman knew about the involvement of Judge Webster in U.S. Technologies and whether the Chairman withheld information from the

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other Commissioners prior to the Commission's vote, (3) determine what vetting of appointees took place, and (4) identify any aspects of SEC's selection and vetting process that contributed to the eventual breakdown in the process.

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## Scope and Methodology

To describe the process and significant events leading up to the Commission's selection of the PCAOB's first members, to determine what the SEC Chairman knew about the involvement of Judge Webster in U.S. Technologies, and to determine whether the Chairman had withheld information from the other Commissioners prior to the Commission's vote, we reviewed thousands of internal documents. These documents included plans, memorandums, and correspondence between and among the Chairman, the Commissioners, the SEC Chief Accountant, other SEC staff involved in the PCAOB selection process, and outside parties. We also used this information to corroborate and verify testimonial evidence collected through extensive interviews of the SEC Chairman; each Commissioner; the Chief Accountant; the General Counsel; the Chairman's Chief of Staff; the PCAOB appointees; and John H. Biggs, who was among those considered for the PCAOB chairmanship. We also obtained information from staff in SEC's Office of the Chief Accountant, the Office of the General Counsel, the Division of Enforcement, the Division of Corporation Finance, and the Office of the Chairman and others within and outside SEC. Finally, we were benefited greatly from technical support and assistance provided by staff in SEC's Office of the Inspector General. We reviewed and used information collected and assembled by staff of the Office of the Inspector General throughout our review. A determination and assessment of the details of Judge Webster's involvement in U.S. Technologies was beyond the scope of this review.

To determine what vetting of appointees took place, we reviewed the SEC Office of the General Counsel's proposed vetting process for the PCAOB appointees and other relevant documentation. We also interviewed SEC's General Counsel and the PCAOB appointees to obtain information about the types of information they provided prior to their appointment to the PCAOB. Likewise, to determine what aspects of SEC's selection and vetting process contributed to the breakdown of the process, we attempted to identify other applicable appointment models to identify common elements of those models with which to compare the process followed by SEC in selecting and vetting PCAOB appointees. Finally, we obtained views from those we interviewed about recommended process improvements.

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We conducted our work in New York, New York, and Washington, D.C., in November and December 2002 in accordance with generally accepted government auditing standards.

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## Results in Brief

When the Sarbanes-Oxley Act of 2002 required SEC to appoint five members to the newly created PCAOB within 90 days, SEC in many ways faced a unique challenge. SEC had not played such a role since 1975 and did not have a formalized and tested process in place that clearly identified and documented the roles to be played by the Commissioners and staff.<sup>1</sup> Initially, the Chairman asked the Chief Accountant to take the lead in identifying potential candidates for the PCAOB, but this approach was never fully endorsed by the other Commissioners.<sup>2</sup> As the selection process evolved, the Commissioners became more involved than originally planned. A lack of consensus among the Commissioners, as well as a lack of staff direction and communication, resulted in SEC's failure to appoint a slate of candidates that would elicit a unanimous vote. The staff's initial plan was to have the slate determined by the end of September, which according to the General Counsel would have left time to conduct some limited vetting of the appointees before October 28. However, this strategy broke down when the Commission was unable to agree upon and attract a consensus candidate to serve as PCAOB chairman. As the statutory deadline approached, SEC was ultimately forced to appoint members to the PCAOB that had not been adequately vetted.

At the time of the Commission's vote, the Chief Accountant did not inform the SEC Chairman or other Commissioners about certain matters concerning Judge Webster's role as the former chairman of the audit committee of the board of directors of U.S. Technologies. Although the SEC Chairman was aware that Judge Webster had been the chairman of the audit committee and that the company was failing, he had previously been told that Judge Webster's involvement in U.S. Technologies did not

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<sup>1</sup>SEC was involved in establishing the Municipal Securities Rulemaking Board, which was created under the Securities Acts Amendments of 1975, Pub. L. No. 94-29, §13, to regulate brokers, dealers, and banks dealing in municipal securities.

<sup>2</sup>Under Reorganization Plan No. 10, most of the Commission's executive and administrative functions were transferred to the SEC Chairman, including the appointment and supervision of Commission personnel, distribution of business among the administrative units, and the use and expenditure of funds. Moreover, the Chairman effectively sets the agenda and policy direction for the Commission and determines what issues staff bring before the Commission.

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pose a problem. We found no evidence that the SEC Chairman was informed of any other information about the company's history and Judge Webster's role prior to the October 25 vote on the PCAOB candidates. Staff in the Office of the Chief Accountant did not review much of the relevant periodic filings containing information raising concerns about auditing-related issues at U.S. Technologies until the morning of the October 25 vote. Although information contained in these filings was reviewed by the Chief Accountant, on the basis of his review of available information, his experience as an auditor, his knowledge of Judge Webster's previous federal service, and an understanding that additional vetting would occur post-appointment, the Chief Accountant concluded that this information did not have a bearing on Judge Webster's suitability to be nominated to serve on the PCAOB. Therefore, the Chief Accountant did not share what he knew with the Chairman or the other Commissioners prior to the October 25 vote.

As the Judge Webster appointment illustrates, the five appointees were not systematically vetted prior to appointment to the PCAOB. The SEC Chairman and staff initially planned that the Office of the General Counsel would conduct some vetting prior to selection. In addition to administering certain details, the General Counsel was a resource for potential nominees who had questions about appointment to the PCAOB. However, after the selection process broke down in early October when the Commission was unable to agree on a consensus candidate for chairman, the General Counsel was forced to initiate the vetting process on a post-appointment basis. The Commission was made aware of this fact at the time of the October 25 vote. The vetting process was still ongoing at the time of our review.

SEC faced many challenges in selecting the first PCAOB and will not have to appoint five members in a 90-day time frame again. Nevertheless we found that SEC did not take steps that could have contributed to a more efficient selection process. First, it did not take sufficient steps to reach consensus on the process to be followed among the Commissioners and SEC staff before they appointed the PCAOB members. Second, SEC did not identify or systematically utilize any selection criteria beyond the broad criteria specified in the act to consider candidates for PCAOB membership. Thus, uncertainty existed about the composition of the PCAOB and views on the qualifications for board membership varied among the Commissioners and SEC staff. Finally, SEC did not develop and articulate a documented, public, or agreed-upon process for screening candidates before they were interviewed and appointed by the Commissioners; nor did the Commission and staff collectively determine

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how and what information would, and should, have been developed and passed along for their consideration as they deliberated about candidates.

Given the vitally important role of the PCAOB in addressing corporate oversight and investor protection concerns, we are making several recommendations in this report that are aimed at improving SEC's PCAOB selection and vetting process prior to the appointment of any new PCAOB members. First, we recommend that the Commission reach agreement upon and document the process to be followed, the proper sequence and timing of key steps, and the roles to be played by the Commission and SEC staff in the selection and vetting of candidates. In so doing, we recommend that the Commission develop agreed-upon selection criteria for PCAOB members and chairman that embrace the intent of the act. We also recommend that the Commission develop a vetting process that ensures that before an applicant is brought to the Commission for serious consideration, certain minimum background checks are performed in connection with the individual and that the vetting process be completed before the Commission votes to appoint members to the PCAOB. Further, we recommend that SEC determine how such information on potential nominees should be documented, analyzed, and shared among the Commissioners and staff. Finally, we recommend that SEC make greater use of available technology to conduct necessary background checks that generate sufficient details about the qualifications of potential applicants so that the Commission can make both timely and informed decisions on the fitness of potential applicants for the PCAOB.

We requested comments on a draft of this report from all five SEC Commissioners, SEC's General Counsel, SEC's former Chief Accountant, the Chairman's former Chief of Staff, and others at SEC involved in the selection and vetting process. In addition, we requested comments from Judge Webster and Mr. Biggs. Each of these parties provided only technical comments on the report's contents, which were incorporated as appropriate. The Chairman and each of the other four Commissioners also told us that they generally agreed with the report's recommendations.

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## Background

The act specifies that the PCAOB is to consist of five, full-time members, with one being designated as the chairman. According to the act, each PCAOB member is to have a demonstrated commitment to the interests of investors and the public, an understanding of issuers' financial disclosure requirements, and an understanding of the obligations of accountants with respect to the preparation of audit reports. The act also specifies that two, but no more than two, members be certified public accountants (CPA).



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PCAOB members generally are expected to serve 5-year terms. However, to establish staggered terms of office, the terms of office of the initial PCAOB expire in annual increments, ranging from 1 to 5 years, with the chairman serving a 5-year term.

Although its activities are subject to SEC oversight and approval, the PCAOB is an independent board with sweeping powers and authority. It has the authority to

- register public accounting firms that prepare audit reports for companies that issue securities to the public (issuers);
- establish rules for auditing, quality control, independence, and other standards relating to the preparation and issuance of audit reports for issuers;
- conduct inspections of registered public accounting firms and associated persons;
- conduct investigations and disciplinary proceedings and, where justified, impose appropriate sanctions upon registered public accounting firms and associated persons;
- perform other duties or functions determined necessary or appropriate to promote high, professional standards among public accounting firms and associated persons;
- enforce compliance with the act, the rules of the PCAOB, professional standards, and the securities laws relating to the preparation and issuance of audit reports by registered public accounting firms and associated persons; and
- set the budget and manage the operations of the PCAOB and its staff.

The newly created PCAOB is to be structured as a nonprofit corporation that is funded by fees assessed on public companies. The act specifies that PCAOB members, employees, and agents are not considered employees of the federal government.

The act requires SEC to appoint PCAOB members and verify that the organization meets its statutory responsibilities. Specifically, the act requires that SEC, in consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, appoint the initial five-member board within 90 days of the act's passage—that is, by October 28, 2002. Within 270 days of enactment, SEC is to determine that the PCAOB has taken actions necessary to carry out its mission. These actions include hiring staff, proposing rules, and adopting initial and transitional auditing and other professional standards. Within 180 days of SEC's determination that the PCAOB is meeting its

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statutory responsibilities, any public accounting firm that is not registered with the PCAOB may not participate in the preparation or issuance of any audit report for any public company that issues securities to the public.

SEC is an independent agency comprising five presidentially appointed commissioners, 4 divisions, and 18 offices. In total, SEC has approximately 3,100 staff. SEC is headquartered in Washington, D.C., and it has 11 regional and district offices throughout the country. To ensure that the Commission remains nonpartisan, no more than three commissioners may belong to the same political party. The President also designates one of the commissioners as chairman, the SEC's top executive. The commissioners meet to discuss and resolve a variety of issues that staff bring to their attention. At these meetings, the commissioners interpret federal securities laws, amend existing rules, propose new rules to address changing market conditions, and/or take action to enforce rules and laws. These meetings are open to the public and the news media, unless the discussion pertains to confidential subjects such as whether to begin an enforcement investigation.

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## SEC Strategies Evolved in Response to Major Events Leading to the Appointment of PCAOB Members

Faced with appointing five members to the newly created PCAOB in 90 days, SEC lacked a formalized and tested process that documented the roles to be played by the Commissioners and staff. The SEC Chairman initially asked the Chief Accountant to take the lead in identifying potential PCAOB members; however, the other Commissioners never fully endorsed this approach. A lack of consensus among the Commissioners and a lack of staff direction and communication resulted in SEC's failure to find a slate of candidates that would elicit a unanimous vote from the Commission. Moreover, these events ultimately resulted in SEC appointing members to the PCAOB that had not been fully vetted.

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## Initial Strategy for the Selection and Vetting Process

In requiring SEC to appoint members to the PCAOB within 90 days, the act posed a unique challenge for SEC. SEC had not in recent history conducted a similar selection process; therefore, it lacked formalized and tested procedures that were familiar to the Commissioners and SEC staff. The actual process used to appoint PCAOB members was not documented and evolved as the statutory deadline for appointing members approached. Upon passage of the act, the Chairman designated the SEC's Chief Accountant to lead the search for and identification of PCAOB nominees, with assistance from the General Counsel, who was assigned to vet the candidates. The Chief Accountant began identifying potential candidates for the PCAOB from a wide range of sources, including current and prior

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Commissioners, Members of Congress, government officials, regulatory organizations, trade associations, and industry leaders. SEC also solicited input from the public through an August 1, 2002, release asking for nominations and applicants willing to serve on the PCAOB.<sup>3</sup> As required by the act, early in the process, the SEC Chairman began to consult with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury to obtain their input and suggestions for potential PCAOB candidates.

Early in the selection process, the SEC Chairman's goal was to find an outstanding candidate as chairman, an individual of great stature who could reassure investors and receive unanimous support from the Commission. The SEC Chairman initially planned that he, along with a Democratic Commissioner and the Chief Accountant, would approach candidates for the chairmanship. The Chairman said that he believed this would help make the process bipartisan. The SEC Chairman wanted the Chief Accountant to participate because he was the person within SEC who would have the most contact with the PCAOB chairman; therefore, he needed to be comfortable with the selection. However, at least one Commissioner told us that the reason for this approach was neither communicated to him nor fully understood by him.

Given that the nominees were being considered for service on a board that was designed to help restore investor confidence in financial reporting systems and to clean up perceived problems in the accounting profession, the SEC Chairman said that the PCAOB, and thus each of its members, must be beyond reproach. To achieve that end, the Chairman asked the General Counsel to vet nominees and, at a minimum, identify any significant potential problems or conflicts, real or perceived, involving accounting and other related issues. The General Counsel said that he saw his role as working with the Office of the Chief Accountant to develop an application to collect financial and background information from appointees, to select a contractor to conduct background checks on the appointees, and to identify other steps to vet the slate of candidates selected by the Commission. The staff initially planned to have the slate of potential PCAOB candidates determined by the end of September, which the General Counsel thought would have provided time to do at least some vetting of the appointees before the October 28 deadline. It is unclear whether the other Commissioners were informed of or fully endorsed this

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<sup>3</sup>By the October 25 vote, SEC had compiled a list of more than 450 names.

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plan; some of the Commissioners wanted more involvement in the process and thought it best for each Commissioner independently to do due diligence on potential candidates. This selection strategy broke down when the Commissioners, lacking a documented and formalized process, were unable to agree upon and follow a strategy to identify, vet, and select members to the PCAOB and attract a consensus candidate to serve as chairman.

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## Major Events Leading to the Appointment of the First PCAOB

In August 2002, according to those involved in the process, Paul A. Volcker, the former Chairman of the Board of Governors of the Federal Reserve System, emerged as the consensus choice for PCAOB chairman. The SEC Chairman, a Democratic Commissioner, and the Chief Accountant tried throughout August to persuade Mr. Volcker to consider serving as PCAOB chairman. The SEC Chairman also asked the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and others to assist him in persuading Mr. Volcker. In early September, Mr. Volcker declined to be considered for appointment, in part because the full-time nature of the position required him to give up outside interests that were important to him. In September, the SEC Chairman, the Democratic Commissioner, and the Chief Accountant shifted their focus to Mr. Biggs, the retiring Chief Executive Officer of Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF).

On September 11, the Chairman, the Democratic Commissioner, and the Chief Accountant met with Mr. Biggs to discuss his interest in serving on the PCAOB. According to those involved, the purpose of the meeting was to persuade Mr. Biggs to agree to be considered for the chairmanship of the PCAOB. At this meeting, the Chairman and the Democratic Commissioner in attendance told Mr. Biggs that he would have their support. However, the SEC Chairman also stated that his final decision would rest in what he hoped would be a unanimous decision by the Commission. Mr. Biggs said that he told the SEC Chairman that he would only serve on the PCAOB if he were appointed its chairman. The following week, Mr. Biggs called the Chairman and the Chief Accountant to say that he was willing to be considered. On September 24, Mr. Biggs met with a third Commissioner who also gave his support, thereby giving Mr. Biggs enough votes for a majority. Mr. Biggs subsequently met with the remaining two Commissioners and other SEC staff on September 27. For the Chairman, support of Mr. Biggs was contingent upon another specific individual being appointed to the PCAOB. Therefore, when one of the Commissioners informed the Chairman (around Sept. 27) that another

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Commissioner might not be willing to support that individual, the Chairman became less willing to support Mr. Biggs.

The SEC Chairman continued to discuss throughout September other candidates who could potentially serve as chairman or members of the PCAOB. Although potential appointees to the PCAOB had been the subject of ongoing media speculation, on October 1, a newspaper article indicated that Mr. Biggs had “agreed to be the first head of a new regulatory oversight board for the accounting profession.”<sup>4</sup> According to those we interviewed, this article upset some of the Commissioners because it said that the job had been offered to Mr. Biggs. Some of the Commissioners said that the article made them feel that their vote was irrelevant to the selection of the chairman. The SEC Chairman telephoned Mr. Biggs on October 2 and informed him that the October 1 article had “complicated things” and threatened the Chairman’s desire to achieve a unanimous vote. Although the article reported that Mr. Biggs declined to be interviewed, the article, together with a subsequent article that appeared on October 4, led some of the Commissioners to believe that Mr. Biggs was the source of the information included in the articles, directly or indirectly.<sup>5</sup> As a result, some of the Commissioners raised serious questions about Mr. Biggs’s independence, judgment, and ability to effectively work on the PCAOB. At this point, the Commission became divided, with at least one Commissioner willing to support only Mr. Biggs as the chairman and others who strongly opposed Mr. Biggs’s nomination as chairman.

SEC’s Chairman and Chief Accountant said that they originally planned for the Commissioners to meet with only about five to seven PCAOB candidates, who would be identified by the Chief Accountant. Again, this approach was not communicated to or endorsed by all of the Commissioners. Therefore, in late September, with time running out and little progress made in selecting candidates, the selection process changed. At the urging of one of the Commissioners, the Chief Accountant and each of the Commissioners began to interview candidates. In total, each Commissioner interviewed about 25 candidates for the PCAOB from late September to October. Although the SEC Chairman and the Chief Accountant were considering a number of candidates, Judge Webster, former Director of the Federal Bureau of Investigation (FBI) and the

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<sup>4</sup>*The New York Times*, “Chief of Big Pension Plan Is Choice for Accounting Board,” October 1, 2002.

<sup>5</sup>*The New York Times*, “SEC Chief Hedges on Accounting Regulator,” October 4, 2002.

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Central Intelligence Agency, emerged as a leading candidate for PCAOB chairman. Although his name had surfaced in early August along with others, he was not seriously pursued at that time. According to Judge Webster, the SEC Chairman first contacted him on September 27 about considering a position on the PCAOB and later sent him some background material. On October 15, Judge Webster met with the SEC Chairman, the Chief Accountant, and the SEC Chairman's Chief of Staff, who urged Judge Webster to consider serving as PCAOB chairman. They discussed a number of items at this meeting. At some point during the meeting, the Chairman said that there was one reason for Judge Webster not to consider the position, which was that Judge Webster's nomination would be criticized by some and that he could be attacked in the media. According to those in attendance, Judge Webster said that he had been confirmed by the Senate for other federal posts on five occasions and nothing in his past would pose a problem. He added that people might make something out of the fact that he was the former chairman of the audit committee of the board of directors of U.S. Technologies, a company that he described as on the brink of failure. According to Judge Webster, he also asked the SEC officials at that meeting to check SEC's records to see if they indicated any problems relating to U.S. Technologies. As discussed in detail in the next section, an initial review of this matter conducted by staff in SEC's Office of the Chief Accountant did not reveal, in the Chief Accountant's opinion, any disqualifying problems involving Judge Webster's role in the company. Based on the information he obtained, the Chief Accountant passed along information to the Chief of Staff, indicating that there was no problem with Judge Webster's involvement in U.S. Technologies. The Chief of Staff communicated that message to the SEC Chairman. Neither the information provided by Judge Webster nor collected by the Chief Accountant was provided to SEC's General Counsel for vetting purposes.

On October 21, Judge Webster met with the SEC Chairman and the Chief Accountant to discuss the position further. According to Judge Webster, the Chief Accountant and the SEC Chairman independently told Judge Webster on October 22 or 23 that his involvement with U.S. Technologies would not be a problem. Judge Webster also spoke, in person or on the telephone, with the other Commissioners and the General Counsel on or around October 22, but U.S. Technologies was not mentioned or discussed. Late in the afternoon of October 23, Judge Webster agreed to have his name considered for PCAOB chairman. The SEC Chairman and the Chief Accountant finalized the choices for the other members of the PCAOB and developed a five-member slate on October 24. On that day, in part due to concerns about a leak to the press, the draft slate was not

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shared with the full Commission. However, the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System were informed of the draft slate on October 24, and at the request of the SEC Chairman, they signed a joint letter endorsing Judge Webster and the other members on the slate.

There was additional research into Judge Webster's involvement with U.S. Technologies after Judge Webster agreed to have his name submitted for consideration on October 23. On October 24, the Chief Accountant received a draft newspaper article, which mentioned that Judge Webster had served on the board of directors of several companies, including U.S. Technologies. This prompted the Chief Accountant to ask one of his staff to do some additional follow up on any open or closed enforcement activity concerning U.S. Technologies. This review also included a review of certain corporate disclosures filed with SEC by U.S. Technologies, including documents indicating that the company had dismissed its external auditor a month after material internal control weaknesses were reported. The Chief Accountant received this information on the morning of October 25, a few hours before the scheduled open meeting of the Commission. Again as discussed in detail in the next section, in the opinion of the Chief Accountant, this review revealed nothing that would have disqualified Judge Webster as a nominee. Therefore, the Chief Accountant did not pass on any information about U.S. Technologies or Judge Webster's role to the SEC Chairman or the other Commissioners to consider prior to their vote to appoint members to the PCAOB. He also did not share this information with the General Counsel.

The SEC Chairman said that he and the Commissioners had planned to vote seriatim—whereby the slate of nominees would be passed among the Commissioners for signature—on Thursday, October 24, rather than holding an open Commission meeting. However, on October 23, one of the Commissioners requested an open meeting. On the morning of the October 25 vote, the Office of the Chief Accountant provided the Commissioners with the slate of names for the PCAOB and formally notified them that vetting would occur post-appointment. At the open meeting, one Commissioner voted against all of the board nominees, stating that the selection process was inept and seriously flawed. Another Commissioner voted against Judge Webster, stating that he was not as qualified for the post as Mr. Biggs, but voted in favor of the remaining slate. The SEC Chairman and the remaining two Commissioners voted in favor of the slate of five. Judge Webster therefore was approved by a vote of three to two, and the remaining PCAOB nominees were approved by a vote of four to one.

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Staff in the Office of the Chief Accountant continued to research matters associated with U.S. Technologies from the morning of the vote into the week of October 28. On October 31, allegations emerged that the SEC Chairman, before the October 25 vote, withheld from his fellow Commissioners material information about Judge Webster's role at U.S. Technologies, which was relevant to the appointment of Judge Webster as chairman of the PCAOB.<sup>6</sup> Later that same day, the SEC Chairman and another Commissioner separately called the SEC Inspector General to investigate these allegations. The SEC Chairman also asked the SEC Office of the General Counsel to conduct an investigation into Judge Webster's involvement with U.S. Technologies.

Amid the subsequent controversy, the SEC Chairman announced his intention to resign on November 5, the Chief Accountant announced his resignation on November 8, and Judge Webster resigned from the PCAOB on November 12, effective upon the appointment of a new chairman. To date, the PCAOB has had two planning meetings, which have included Judge Webster. The PCAOB is expected to hold its first official meeting on January 6, 2003, at which time members' terms officially begin. At this time, no acting chairman or replacement chairman has been appointed to the PCAOB. See appendix I for a more detailed chronology of major events.

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## Chief Accountant Did Not Inform the Commission of Issues at U.S. Technologies Prior to the Vote

As discussed above, the Office of the Chief Accountant performed two reviews into Judge Webster's involvement in U.S. Technologies prior to his appointment as PCAOB chairman. According to those in attendance, in an October 15 meeting, which included the SEC Chairman, the Chief Accountant, and the Chairman's Chief of Staff, Judge Webster mentioned that he had formerly served as chairman of the audit committee of the board of directors of U.S. Technologies, a company on the brink of failure. He said that he asked SEC officials at that meeting to check SEC's records to see if they indicated any problems relating to U.S. Technologies.<sup>7</sup> According to the SEC Chairman, he told Judge Webster that they would contact him if any problems were found. Following this meeting, the SEC

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<sup>6</sup>*The New York Times*, "Audit Overseer Cited Problems in Previous Post," October 31, 2002.

<sup>7</sup>Judge Webster told us that he was not concerned about the financial activities of the company, given that the company was receiving clean audit opinions from its external auditors. However, he said that he was concerned about certain activities of the company's chief executive.



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Chairman asked the Chief Accountant to look into U.S. Technologies. No one who attended the meeting contacted SEC's General Counsel, who was responsible for vetting PCAOB candidates. Instead, the Chief Accountant asked his secretary to follow up on whether there were any open or closed SEC investigations of the company. Contact with the Division of Enforcement revealed that SEC was looking into allegations of misconduct by an officer of U.S. Technologies, not Judge Webster, involving a Schedule 13D filed in 1999.<sup>8</sup> Staff in the Office of the Chief Accountant received information from Enforcement staff that led them to believe that Enforcement staff expected to close the matter. Because the matter involved an officer of U.S. Technologies and not the company directly nor the activities of its board of directors, the Chief Accountant concluded that this did not affect Judge Webster's nomination to serve as chairman of the PCAOB. According to the Chief Accountant, he passed along information from Enforcement staff to the SEC Chairman's Chief of Staff that indicated there was no problem as a result of Judge Webster's involvement with U.S. Technologies, and the Chief of Staff reported the same to the SEC Chairman. According to Judge Webster, the SEC Chairman and Chief Accountant independently informed him on October 22 or 23 that his involvement in U.S. Technologies would not pose a problem. The SEC Chairman said that he recalled contacting Judge Webster, but the Chief Accountant said that he did not recall contacting Judge Webster.

There was a second inquiry into U.S. Technologies and Judge Webster by the Office of the Chief Accountant. This inquiry was prompted late on October 24 when the Chief Accountant reviewed a draft newspaper article, which mentioned that Judge Webster had formerly served on the board of directors of U.S. Technologies and had served as the chairman of its audit committee until July 2002. The Chief Accountant asked one of his staff to do some additional follow up but indicated that he thought it was "clean" on the basis of the initial review. This second review, as described in greater detail in figure 1, included examining certain corporate disclosures that U.S. Technologies filed with SEC, such as the most recent annual and quarterly filings. Early on the morning of October 25, staff became aware that the company had disclosed in a 2001 filing that it dismissed its external auditor in August 2001, a month after the auditor informed the

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<sup>8</sup>The Securities Exchange Act of 1934, Section 13(d), requires certain persons who acquire beneficial ownership of more than 5 percent of certain classes of equity securities to file an appropriate disclosure with SEC. These disclosures are usually made on a Schedule 13D.

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company of material internal control weaknesses. Upon learning about the change in auditor, staff in the Office of the Chief Accountant did not contact Judge Webster to obtain additional information on this issue, nor did they contact other audit committee members, the company, the current or former external auditor, or the SEC General Counsel.

**Figure 1: Detailed Analysis of the Office of the Chief Accountant's Second Review of U.S. Technologies**

On October 24, the Chief Accountant asked his staff to conduct an additional review of U.S. Technologies. Unlike the initial review, which focused solely on open or closed enforcement activity involving U.S. Technologies, this review included examining certain corporate disclosures that the company filed with SEC. On the morning of October 25, staff found the following:

- Judge Webster was the chairman of the audit committee of the board of directors and thus had signed the annual report filed in April 2002. Staff found that there might also be issues concerning the timeliness of certain filings.
- U.S. Technologies filed a Form 8-K in August 2001 indicating that it had dismissed its external auditor. (The Form 8-K indicated that U.S. Technologies had requested its external auditor to furnish a letter addressed to SEC stating that it agreed with the information and providing any appropriate disclosure.)
- U.S. Technologies filed a Form 8-K-A, or an amendment to the August 2001 Form 8-K in September 2001, which included a letter from the company's former external auditor, stating that the company agreed with its former external auditor's assessment that the auditor had informed the company of material internal control weaknesses in a telephone conference call in July 2001 and a management letter that was issued in August 2001. (These weaknesses related to lack of an experienced chief financial officer, deficiencies in recording material transactions timely and the organization and retention of financial and accounting documents.)
- U.S. Technologies filed a third Form 8-K in November 2001, disclosing that its board had hired a new external auditor.
- Judge Webster and the other directors resigned on July 19, 2002.
- The litigation sections of U.S. Technologies's annual and quarterly filings discussed several lawsuits in which the company was involved. None of the lawsuits were determined to involve Judge Webster or the companies' financial reporting.

During the week of October 28, staff in the Office of the Chief Accountant continued to collect information on U.S. Technologies. For example:

- On October 29, staff contacted the Division of Enforcement staff and confirmed that the open matter involving the Schedule 13D filed by a U.S. Technologies officer remained open, but staff from the Office of the Chief Accountant received information from the Division of Enforcement staff that lead them to believe that the matter would be closed. Staff from the Office of the Chief Accountant also inquired about whether it was considered a financial fraud case and obtained information that lead them to believe that it was not.
- On October 30, staff from the Office of the Chief Accountant contacted the Division of Corporation Finance to find out whether the division had reviewed certain U.S. Technologies's filings. The internal tracking system indicated no evidence of a review. According to Division of Corporation Finance staff, apparently the August and September filings were never assigned to a reviewer. However, there was evidence that the division reviewed and cleared the November filing without comment, which indicated that division staff determined that the proper disclosures were made.

Based on the research into U.S. Technologies that began on October 25 and continued into the following week, staff concluded that none of the identified items raised concerns about Judge Webster's involvement in the activities of U.S. Technologies because each item appeared to have been in the normal course of business—especially in light of the company's progression into bankruptcy.

Source: GAO analysis of SEC staff documents and staff interviews.

Note: SEC requires a publicly held company to file a Form 8K when the company changes its auditor.

Similar to his initial determination of October 15, the Chief Accountant evaluated the additional information that had been collected, including information on U.S. Technologies's change in external auditor and determined that, in his view and his staff's view, nothing had come to light

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that affected the suitability of Judge Webster to serve as PCAOB chairman. The Chief Accountant told us that his decision was based on his review of financial disclosure documents filed with SEC; his experience as an auditor; the stature and reputation of Judge Webster, who had been confirmed by the Senate five times; and his knowledge that additional vetting would occur post-appointment. The Chief Accountant also said the documents filed with SEC by U.S. Technologies, which were determined to be late and reported internal control weaknesses, described problems that were not unusual in small, rapid-growth companies. He said that such companies often outgrow their existing financial and accounting systems and the capacity of their chief financial officers. Moreover, he was persuaded by the fact that U.S. Technologies's auditor had ultimately given the company a clean opinion. Having decided that U.S. Technologies posed no problems with regard to Judge Webster's nomination, the Chief Accountant did not believe that he needed to share this information with the SEC Chairman or the other Commissioners. The Chief Accountant said that he had made a similar judgment about Mr. Biggs who had been on the audit committee of the board of directors of McDonnell-Douglas when it entered into a consent decree with SEC regarding issues involving accounting irregularities several years ago.

According to the SEC Chairman, he knew that Judge Webster was the former chairman of the audit committee of the board of directors of U.S. Technologies before the October 25 vote. He said that he learned after the vote that law enforcement authorities were investigating the Chief Executive Officer of U.S. Technologies. Specifically, Judge Webster told us that he telephoned the SEC Chairman on October 28 to inform him that he had learned during the weekend of October 26 and 27 that law enforcement was investigating U.S. Technologies's Chief Executive Officer. Further, the SEC Chairman and the other Commissioners told us that they learned for the first time of reported "allegations of fraud" against U.S. Technologies and that the company had dismissed its external auditor following an audit that uncovered material internal control weaknesses from a reporter's inquiry on October 30 or from the October 31 newspaper article.<sup>9</sup> This disclosure prompted the SEC Chairman to ask the General Counsel to investigate Judge Webster's role in these matters. The Office of the General Counsel has subsequently suspended the investigation due to Judge Webster's resignation.

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<sup>9</sup>*The New York Times*, "Audit Overseer," October 31, 2002.

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## Vetting Process Was Initiated Post-Appointment

Vetting candidates is a vital component of the appointment process. The General Counsel was asked to vet the appointees, and according to the SEC Chairman, he expected that some vetting and background checks would be performed by the General Counsel on candidates throughout the process. Although the Chairman said that he knew that some vetting would occur post-appointment, he was surprised at how little was done before the vote. We found that after the selection process broke down in early October and Commissioners began to interview a larger number of candidates than staff originally planned, the General Counsel met with many but not all of the potential candidates who were interviewed. Specifically, the General Counsel told us that prior to October 25, he had met with 17 of the roughly 25 candidates who were interviewed. However, the Office of the Chief Accountant did not schedule meetings for him with three of the five individuals who were ultimately appointed to the PCAOB.

The General Counsel said that he understood that his role in interviews with candidates beginning in early October was to address questions regarding service on the PCAOB, such as pay, location, ethics restrictions, and other matters important to attracting quality candidates. He also informed candidates that they would be required to submit questionnaires and be subject to a background check. The General Counsel said that he expected that the final slate would be subject to additional interviews and vetting. As a result, the candidates with whom he met were not systematically queried about current or previous membership on boards of companies nor were they subject to the other planned elements of the vetting process. For example, we found that SEC also did not systematically use its available internal technological capabilities and resources to the fullest extent possible to begin to collect fundamental information on the applicants being interviewed as it had initially planned to do. Moreover, SEC staff did not consistently search internal databases such as the Name Relationship Search Index (NRSI) and the Electronic Data Gathering and Retrieval System (EDGAR), or periodical databases such as LexisNexis and Westlaw, for any information on potential candidates.<sup>10</sup> Instead, if any candidate brought up an issue that might

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<sup>10</sup>NRSI is an internal SEC system that tracks open and closed investigations, proceedings, and other relevant information. EDGAR is a database system through which public companies electronically file registration statements, periodic reports, and other forms to SEC. In addition to the EDGAR system, which is publicly available, SEC also has an internal system that includes the status of filings reviewed by SEC staff and the results of those reviews. LexisNexis provides authoritative legal, news, public records, and business information. Westlaw is an on-line legal research service, providing a broad collection of legal resources, news, business, and public records information.

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potentially affect his or her fitness to serve, the General Counsel would look into the matter. This occurred in at least two instances during the interview process. The General Counsel met with Judge Webster prior to his appointment, but there was no discussion of U.S. Technologies. The General Counsel said that he first learned of potential concerns about Judge Webster and U.S. Technologies from press inquiries in the days leading up to the October 31 newspaper article.

Early in the selection process, there also was no clearly defined and agreed-upon method for vetting of candidates, and SEC staff considered various approaches to vetting the slate of five candidates. Initially, the Office of the General Counsel explored using the FBI to conduct background investigations into PCAOB appointees. However, because the PCAOB was not a federal government entity and the FBI was unlikely to be able to complete required investigations within SEC's tight time frames, SEC staff decided that it would be more appropriate to hire an outside contractor to perform this role.

The General Counsel agreed to develop an appointee questionnaire that then would be supplied to the outside contractor that would be performing the background checks. It was the General Counsel's expectation throughout the process that background checks would be performed only for the five individuals actually nominated for the PCAOB. Early in the selection process, the SEC Chairman and staff believed that the selection process would be completed by the end of September and that at least some vetting of the appointees would be completed before the October 28 statutory deadline for the appointment of the PCAOB. However, by mid-October the slate had still not been agreed upon and the General Counsel had just hired a contractor to conduct background checks on the appointees. Therefore, it became clear that vetting of candidates could not be completed prior to appointment and the General Counsel concluded that it would be necessary to vet the PCAOB members post-appointment. Ultimately, the General Counsel did not know the final slate of names selected from among those who were interviewed until October 24, the night before the vote. As a result, insufficient time remained to properly vet the PCAOB members prior to their appointment, and the General Counsel and his staff were able to perform only a very limited inquiry into enforcement activities before the Commission's vote. Although some indicated surprise, all of the Commissioners were informed before the vote that background checks had not been performed on the candidates and that the Office of the General Counsel planned to use a questionnaire and outside contractor to vet the appointees. At the

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October 25 Commission meeting, the Commissioners selected the first chairman and members of the PCAOB and authorized background checks.

On November 1, 2002, the Office of the General Counsel formally notified the Commission of the specific steps that staff from the Office of the General Counsel had taken or planned to take to examine the background of each PCAOB member. The Office of the General Counsel also provided the Commissioners with a copy of the questionnaire, which was based on the federal “Questionnaire for National Security Positions” and the “Statement for Completion by Presidential Nominees,” that each PCAOB member was asked to complete. This questionnaire was sent to the PCAOB appointees on November 6, and all documents were completed and returned by November 13. A supplemental questionnaire was sent to the PCAOB appointees on November 14, and all documents were completed and returned to SEC by November 20.

Also on November 1, the Office of the General Counsel provided additional information on the role of CRM Consulting, the private contractor hired to verify the information on the questionnaires. At the time of our review, CRM Consulting was reviewing the appointees’ completed questionnaires and expected to complete its review by the end of the year. SEC staff are to review the information provided by CRM Consulting and look into certain issues, such as outstanding or anticipated lawsuits, administrative proceedings against the member, legal judgments, pending civil or criminal inquiries involving the member in any way, investigations or sanctions of the members by professional associations, financial obligations that might affect a member’s service, potential conflicts of interest, and other matters that if they became publicly known could subject the Commission or the PCAOB to embarrassment or disrespect. In addition to staff from the Office of the General Counsel, staff from the Division of Enforcement will be involved in this process. The Office of the General Counsel had planned to include a review of Judge Webster’s activities involving U.S. Technologies and other relevant matters. However, this review was suspended following Judge Webster’s resignation on November 12. The Office of the General Counsel described the staff review of the background checks as limited; SEC plans to rely primarily on the contractor’s check. The staff review also will not involve an assessment of the sufficiency of the member’s education, professional competence, or experience to serve. The review process was still ongoing at the time of our review.

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## Several Factors Contributed to the Breakdown of SEC's Selection and Vetting Process

Although SEC lacked a documented and formalized selection and vetting process for nominees, several factors contributed to the eventual breakdown of the Commission's ability to select a slate of nominees that could be unanimously appointed. First, lacking formalized and tested procedures familiar to SEC staff and the Commissioners, the SEC Chairman did not reach consensus with the other Commissioners about the process; therefore, the Commission was unable to provide clear direction to staff. Second, the Commission neither agreed upon nor articulated formal selection criteria beyond the general criteria provided by the act. Finally, the lack of pre-appointment background checks and vetting exposed SEC to risks.

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## Selection Process Broke Down in Absence of a Consensus among Commissioners

Perhaps the biggest impediment to the smooth functioning of the selection process was a lack of initial consensus among the Commissioners and key SEC staff on the selection process. As previously mentioned, the Chairman initially decided that staff, primarily the Chief Accountant, who would have most contact with the PCAOB, would drive the effort. Although we found some evidence that staff from the Office of the Chief Accountant and General Counsel had informal meetings about the selection and vetting process in August, the process was not formalized and continued to change over time.

SEC did not find viable solutions to deal with Sunshine Act constraints nor did the staff formalize a selection process and submit a plan to the Commission for its approval.<sup>11</sup> One option would have been to hold an open meeting to discuss and agree to a process. Another option, which was subject to constraints identified by the General Counsel, would have been to hold a closed meeting. However, some of the Commissioners did not want to hold an open meeting because of privacy concerns about potential nominees and public scrutiny. Others were concerned that a closed meeting would have raised questions about the transparency of the process. A third option, which was suggested by at least one of the Commissioners, would have been to formalize the process in writing, circulate it, and reach agreement among the Commissioners. Reaching a consensus through a process meeting early in the process on the roles,

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<sup>11</sup>The Government in the Sunshine Act (Sunshine Act), Pub. L. No. 94-409, § 2, generally requires that every meeting of an agency be open to public observation. Therefore, if more than two SEC Commissioners meet a quorum is present, which requires public notice and the meeting must be open to the public. However, SEC has some latitude in holding a closed meeting to discuss certain matters.

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responsibilities, and duties of the Commission and SEC staff would have helped to provide direction and focus on how the selection process could best be accomplished. Without the benefit of an organizational meeting to share their thoughts and perspectives, it was difficult for the Commissioners to discuss the process and how they thought it should work. Instead, the Chief Accountant usually provided information to the SEC Chairman or his staff, and that information was expected to be relayed to the other Commissioners through weekly meetings between the SEC Chairman and each Commissioner. The SEC Chairman said that he also thought the Chief Accountant was meeting with the other Commissioners, but the Chief Accountant said that he relied to a great extent on the SEC Chairman's weekly meeting with each Commissioner to keep them apprised. As a result, the Chief Accountant and the Chairman acted as intermediaries in keeping the Commissioners involved in the process.

The lack of early consensus and approval of the process by the Commission continued to affect the selection process. For example, some of the Commissioners complained that they were not sure about what was occurring and that they did not want to receive a final slate of names without being able to independently query candidates. As Commissioners raised concerns, the SEC Chairman and the Chief Accountant would adjust the process to accommodate the input provided. For example, early in the selection process, one Commissioner suggested that SEC focus on selecting a chairman and build the rest of the membership around that person. Another Commissioner, unhappy with the lack of a process and the apparent lack of progress, began arranging meetings with candidates on his own. However, he did not initially include the Chairman, which created a problem. Both concerns listed above led to adjustments and expanded the selection process. The Commissioners ultimately were not able to reach agreement on an individual to serve as the chairman, and each of the Commissioners interviewed more candidates than originally planned. The lack of an articulated, agreed-upon process also eroded communications as the deadline drew closer. The evening before the October 25 vote, only three of the five Commissioners were provided with a draft of the names of the final slate.

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### Commission Did Not Have Formalized Selection Criteria Beyond Those in the Act

Although the act provides broad selection criteria, SEC did not develop more specific selection criteria on the composition of the PCAOB other than the two mandated CPA slots. Staff discussed developing more specific selection criteria but decided that any additional criteria might draw criticism from some observers or potentially eliminate otherwise worthy candidates from being considered. Developing more specific



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selection criteria was especially important because the statute provided only broad requirements, and SEC had to use discretion and judgment in making its selections. For example, the act left it up to SEC to decide how much auditing experience the two CPAs should have to serve on the PCAOB. However, SEC staff neither documented nor clearly articulated, what, if any, additional selection criteria SEC planned to use to evaluate the hundreds of names that it had received for consideration on the PCAOB. For example, SEC's August 1, 2002, release restated the broad criteria established by statute that members should be appointed from

“among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.”

However, these criteria alone made it difficult to narrow the list of nominees and applicants.

We considered the process followed by other entities that appoint boards, nominate agency heads, or fill staff positions. Generally, the process includes some sort of selection criteria. For example, the Financial Accounting Foundation (FAF), which appoints members to serve on the Financial Accounting Standards Board (FASB) as terms expire, has specific selection criteria for board membership. In addition to knowledge of financial accounting and reporting and an awareness of the financial reporting environment, FAF's selection criteria include other skills such as critical thinking, communication, and interpersonal skills. Likewise, SEC has a similar process for hiring staff for senior-level positions. Although the task faced by SEC was unique in some respects, there are valid comparisons that can be made; SEC staff also indicated that they considered the FAF approach among others when framing its selection and vetting process. However, we found no evidence that any additional selection criteria were identified, documented, and applied consistently among the candidates. Nor was consistent and sufficient information collected that would have allowed staff and the Commissioners to apply such criteria as considered appropriate.

In keeping with the notion of augmenting the act's selection criteria, the Chief Accountant said that his goal was to create a “balanced” board, which he defined as a diverse board representing a variety of constituencies and ideologies. He also stressed that he and the Commissioners sought a racially and gender-diverse membership. Given

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that the act required that two of the PCAOB's five members be CPAs, the Chief Accountant wanted to ensure that the other members had skills needed to establish a new organization. The Chief Accountant said that he generally categorized nominees or applicants into broad groups, including investor advocates, former chief executive officers or business executives, attorneys, politicians, academics, regulators, and accountants. This approach was also consistent with the FAF model for FASB, which is balanced among academics, investors, industry representatives, and CPAs. However, unlike FAF, this approach does not appear to have been well-articulated or communicated to the Commission or the public, nor does it appear that all members of the Commission ever endorsed the Chief Accountant's balanced board approach. One Commissioner wanted the board to have a strong law enforcement orientation because of the PCAOB's mandate to enforce its regulations and standards. Yet another Commissioner wanted the board to include a majority of "reformers," reflecting what he considered was the purpose of the act. At times, some Commissioners believed that balance also involved political party affiliation. The lack of agreement and open dialogue about these issues hampered the Commission's ability to reach a consensus and eventually contributed to the ineffectiveness of the process. Participants in the process also believed that it was complicated by the involvement of a wide range of external parties and media scrutiny. As a result, the split Commission vote on the PCAOB, most notably the vote on the chairman, raised speculation about the integrity of the process.

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### Lack of Pre-Appointment Background Checks and Vetting Exposed Process to Risk

As previously mentioned, after the Commission was unable to appoint a consensus candidate for PCAOB chairman by the end of September, the Office of the General Counsel was forced to vet the final slate post-appointment. Although the Chairman had tasked the General Counsel with vetting the PCAOB appointees, the Commission and staff did not discuss or reach agreement on the role to be played by the General Counsel in the interview process after early October when the process changed. One method of vetting would have been for the General Counsel, in addition to serving as a resource to candidates, to use a uniform list of questions to ask of potential candidates before the Commissioners interviewed them.<sup>12</sup> Similarly, staff in the Office of the Chief Accountant had developed a list of interview questions that apparently was not used during the interviews,

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<sup>12</sup>In August, staff in the Office of the General Counsel developed a list of questions for vetting the final slate of candidates, but the questions were not used.

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but which would have allowed the interviewers to solicit consistent information from candidates. The General Counsel said that he was not consistently scheduled for interviews with candidates and that he did not see the final slate of candidates until the evening before the vote. Therefore, the General Counsel could not elicit background information, adequately utilize existing SEC databases, or access other publicly available sources to conduct a minimum level of due diligence on potential members' board memberships, affiliations, conflicts of interests, litigation, or other activities that might raise actual or apparent conflicts of interest or raise issues that could hamper the effectiveness of the PCAOB or embarrass the Commission. Due to the process and communication breakdown, the Office of the Chief Accountant in connection with the Office of the General Counsel, the Division of Enforcement, and the Division of Corporation Finance did not explore all internal sources of information early enough or fully enough to ensure that no conflicts existed. The Office of the General Counsel also was not able to review other publicly available sources of information in a timely manner. For example, the Office of the General Counsel could have learned about pending litigation through sources such as Westlaw and LexisNexis. The absence of vetting, while made known to the Commission prior to the vote, may have prevented the Commission from making a fully informed vote about the candidates.

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## Conclusions

Given the short time frame to appoint members and the lack of an existing formalized process, the PCAOB selection process was a difficult undertaking for SEC. Based on our reviews of various correspondence and extensive interviews with the principals involved, it is clear that the Commissioners never collectively discussed establishing a process nor reached consensus on how best to proceed in selecting members for the PCAOB. This lack of consensus was evidenced by a fundamental disagreement about whether the Commissioners should have played a lead role in identifying potential PCAOB candidates or whether the process should have been staff-driven as envisioned by the Chairman. Although Sunshine Act requirements may have made it more difficult for the Commission to reach this much needed consensus, SEC did not identify effective alternative methods for ensuring that the views of all the Commissioners were reflected in the process. As a result, the process changed and evolved over time and was neither consistent nor effective. Although the Commission was informed that background checks and vetting had not occurred before the vote on October 25, the Chairman and Commissioners generally believed that the Office of the General Counsel and/or the Office of the Chief Accountant was undertaking some type of

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vetting of candidates throughout the process. Given the highly scrutinized, political nature of the appointment process, any decisions had to be able to withstand intense public scrutiny and, hence, the lack of vetting proved to be a significant flaw in the selection process.

Based on our reviews of thousands of pieces of correspondence and comprehensive interviews, we found no evidence that the SEC Chairman knew anything before the October 25 vote other than that Judge Webster had once been chairman of the audit committee of the board of directors of U.S. Technologies, a company on the brink of failure. This information, which the SEC Chairman heard from Judge Webster on October 15, was not detailed and did not raise a major concern at that time, and prior to the vote, the Chairman's Chief of Staff had told the Chairman that Judge Webster's involvement in U.S. Technologies was not a problem. However, in making this conclusion, insufficient due diligence was performed by the Office of the Chief Accountant. In addition, the Chief Accountant's failure to communicate any information to the General Counsel, who had responsibility for the vetting process, could have contributed to this incomplete assessment.

When staff in the Office of the Chief Accountant conducted further analysis into U.S. Technologies on October 25, they became aware that the company's 2001 filings disclosed that the company had dismissed its external auditor a month after that external auditor reported material internal control weaknesses related to the company's accounting and financial reporting infrastructure resulting from the lack of an experienced chief financial officer. Based on the factors previously discussed including his experience as an auditor, his knowledge of Judge Webster's long and prominent record of public service, and an understanding that additional vetting would take place post-appointment, the Chief Accountant concluded that this matter did not raise a concern and decided that it was not necessary to inform the Chairman, the other Commissioners, or the Office of the General Counsel of these issues. In light of the current environment surrounding auditors, the role played by audit committees of boards of directors of publicly held companies and the expectation that new members of the PCAOB be beyond reproach, it is clear from our review of the relevant documents that these matters, especially when viewed in the current environment, should have prompted SEC to perform additional, in-depth evaluation before reaching a conclusion about U.S. Technologies and Judge Webster's involvement. Further, in our view, the information concerning Judge Webster's role as chairman of the audit committee of the board of directors of a company that had dismissed its external auditor after the auditor had found material internal control

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weaknesses should have been shared by the Chief Accountant with the SEC Chairman and other Commissioners prior to the vote.

SEC was under enormous pressure in selecting the PCAOB members and had little time to do so. SEC also had difficulty getting certain outstanding individuals to agree to be PCAOB members because of the full-time service requirement and the need for members to give up certain forms of income and other professional or business activities. However, going forward, the Commission will be tasked with establishing a more credible process to replace individual PCAOB members, starting first with selecting a replacement for the chairman and then conducting annual staggered reappointments.

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## Recommendations for Executive Action

Much can be done to improve the selection and vetting process. Before any additional members are appointed to the PCAOB, especially the chairman, we recommend that the Commission

- reach agreement and document the process to be followed, the sequence and timing of key steps, and the roles to be played by the Commission and the staff in the selection and vetting of candidates;
- develop agreed-upon, detailed selection criteria for PCAOB members and the chairman that fully embrace the principles articulated in the Sarbanes-Oxley Act of 2002;
- develop a vetting process that ensures that before an applicant is brought to the Commission for serious consideration, certain minimum background and reference checks are performed to ensure that the individual has no potential legal or ethical impairments and ensure that the vetting process is completed before the Commission votes to appoint members to the PCAOB; and
- determine what candidate information should be documented, analyzed, and shared among the Commission and staff.

Moreover, we recommend that the SEC Chairman, direct staff involved in the PCAOB selection process to make greater use of available technology to conduct necessary background checks and to generate sufficient details on the qualifications of potential applicants so that the Commission can make informed decisions on the fitness of potential applicants to be PCAOB members.

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## Agency Comments

We requested comments on a draft of this report from SEC Commissioners, SEC's General Counsel, SEC's former Chief Accountant,

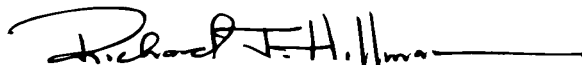
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the Chairman's former Chief of Staff, and others at SEC involved in the selection and vetting process. In addition, we requested comments from Judge William H. Webster and John H. Biggs. Each of these parties provided only technical comments on the report's contents, which were incorporated as appropriate. The Chairman and each of the Commissioners also told us that they generally agreed with the report's recommendations.

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We will send copies of this report to the Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman of the House Committee on Energy and Commerce; the Chairman of the House Committee on Financial Services; and other interested congressional committees. We also will send copies to the Chairman and Commissioners of the SEC, the former Chief Accountant, Judge Webster, Mr. Biggs, and others upon request. In addition, this report is also available on GAO's Web site at no charge at <http://www.gao.gov>.

If you or your staff have any questions concerning this letter, please contact Orice M. Williams or me at (202) 512-8678. Toayoa Aldridge, Wesley Phillips, Derald Seid, David Tarosky, and Barbara Roesmann made key contributions to this report. In addition, Robert Cramer of our Office of Special Investigations and Nelson Egbert and Mary Beth Sullivan of the SEC Office of the Inspector General made key contributions to this report.



Richard J. Hillman  
Director, Financial Markets and  
Community Investment

# Appendix I: Summary of Key Events Associated with the Selection of the Public Company Accounting Oversight Board

Date (2002)	Event
July 30	Sarbanes-Oxley Act of 2002 is signed into law, requiring the Securities and Exchange Commission (SEC) to appoint a five-member Public Company Accounting Oversight Board (PCAOB) within 90 days.
August 1	Chairman delegates responsibility for identifying candidates for the PCAOB to the SEC Chief Accountant. The General Counsel was tasked with vetting candidates. The legislative deadline to appoint the board is October 28, but SEC staff plan to complete the process by September 30.
	SEC issues a release calling for nominations and applications for the board to be submitted by September 2. SEC also begins to directly solicit names of potential candidates from various stakeholders. <sup>a</sup>
Early August	Paul A. Volcker emerges as the consensus choice for PCAOB chairman.
August 9	SEC Chairman has initial meeting with the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System to discuss candidates and obtain input.
August 14	List of PCAOB candidates with 210 names is distributed to the Commissioners.
August 18	Chief Counsel in the Office of the Chief Accountant suggests that a meeting be scheduled to discuss the mechanics of selecting the members of PCAOB.
August 23	Office of the General Counsel formalizes procedures for vetting candidates.
August 26	Chief Accountant recommends that SEC engage a private firm to conduct background investigations of PCAOB candidates.
August 28	Updated list of candidates with 325 names is distributed to the Commissioners.
September 2	SEC cutoff date for receipt of nominations and applications.
	SEC Chairman, one Democratic Commissioner, and the Chief Accountant meet with Mr. Volcker in New York City to discuss the PCAOB chairmanship position. Mr. Volcker agrees to inform SEC Chairman of his decision by September 5.
September 5	SEC learns that Mr. Volcker will not accept the chairmanship.
September 11	SEC Chairman, a Democratic Commissioner, and the Chief Accountant meet with John H. Biggs in New York City to discuss the PCAOB chairmanship.
Mid-September	Charles Niemeier, PCAOB appointee, receives call from the Office of the Chief Accountant requesting a copy of his résumé.
September 19	Kayla Gillan, PCAOB appointee, receives call from the Office of the Chief Accountant to schedule a telephone conference with the Chief Accountant.
September 20	SEC Chief Accountant interviews Ms. Gillan by telephone.
September 23	Willis Gradison, PCAOB appointee, receives call from the Office of the Chief Accountant requesting a copy of his credentials.
September 24	Mr. Biggs meets in New York with third Commissioner.

**Appendix I: Summary of Key Events  
Associated with the Selection of the Public  
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<b>Date (2002)</b>	<b>Event</b>
September 25	Ms. Gillan meets in New York with one Commissioner.
September 26	Ms. Gillan and Mr. Biggs meet in New York City at the suggestion of a Commissioner.
	One Commissioner schedules interviews with fellow Commissioners for Ms. Gillan and another candidate. The Chairman was not included.
Late September	Office of the Chief Accountant begins scheduling interviews of PCAOB candidates with the Commissioners. Mr. Gradison receives a call from the Chief Accountant to come in for interviews. Mr. Niemeier is also asked to come in for interviews.
September 27	For the Chairman, Mr. Biggs's appointment is contingent upon another specific individual being appointed to the PCAOB. One of the other Commissioners informs the Chairman that a Commissioner may not be willing to support that individual.
	SEC Chairman calls William H. Webster to ask him to consider taking a position on the new PCAOB.
	Mr. Biggs has meetings with two Commissioners at SEC headquarters.
September 27-30	Two Commissioners inform the SEC Chairman that three of the Commissioners are unclear as to what is the PCAOB selection process, which they urge the Chairman to articulate. The two Commissioners suggest that all five Commissioners have a meeting about the selection process and "discuss where we are and where we are going."
September 30	Daniel Goelzer, PCAOB appointee, receives a call from the Chief Accountant requesting a copy of his résumé.
October 1	Article in <i>The New York Times</i> reports that Mr. Biggs had "agreed to be the first head" of PCAOB.
	Ms. Gillan meets with three Commissioners at SEC headquarters.
	Mr. Biggs and the Chairman of the Board of Governors of the Federal Reserve System speak by telephone about the PCAOB.
October 2	SEC Chairman calls Mr. Biggs to inform him that the prior day's newspaper article had created consternation at SEC and "complicated things" regarding the consideration of Mr. Biggs for chairman of PCAOB.
	Mr. Goelzer meets with the SEC Chairman and the Chief Accountant.
	Mr. Gradison has meetings with three Commissioners at SEC headquarters.
October 3	Mr. Goelzer has meetings with remaining four Commissioners at SEC headquarters.
	Mr. Gradison has meetings with the Chief Accountant, one Commissioner, and the SEC Chairman.



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<b>Date (2002)</b>	<b>Event</b>
October 4	<p>Article in <i>The New York Times</i> alleges that the SEC Chairman was “backing away from” Mr. Biggs as PCAOB chairman. For the SEC Chairman, this raises questions about Mr. Biggs’s independence.</p> <p>Through the issuance of a Statement of Work and Request for Quotations (RFQ), SEC solicits bidders to conduct background investigations of prospective PCAOB members. The RFQ requests that quotations be furnished by October 8.</p>
October 8	Mr. Niemeier meets individually with Commissioners at SEC headquarters.
October 11	Ms. Gillan has telephone interview with the SEC Chairman.
October 15	<p>Judge Webster meets at SEC headquarters with the SEC Chairman, the Chief Accountant, and the Chairman’s Chief of Staff, who together explain to Judge Webster the value he could bring to the PCAOB. During this meeting, Judge Webster mentions that he was the former chairman of the audit committee of the board of directors of U.S. Technologies, Inc.</p> <p>At the request of staff in the Office of the Chief Accountant, staff in SEC’s Division of Enforcement searches the Name Relationship Search Index database for information on U.S. Technologies.</p> <p>Around this time, the Office of the General Counsel realized that vetting would have to be completed post-appointment.</p>
October 17	<p>The Office of the Chief Accountant and the Office of the General Counsel file an Order for Supplies or Services to have Contract Resource Management, Inc. (CRM), conduct background investigations on PCAOB appointees. The order is for five to eight background investigations.</p> <p>During a meeting with the Federal Reserve Chairman concerning a supervisory matter, the SEC Chairman shared several names of potential nominees for the PCAOB.</p>
October 21	Judge Webster meets with the SEC Chairman, the Chief Accountant, and the Chairman’s Chief of Staff at SEC headquarters a second time to again discuss the possibility of Judge Webster serving on PCAOB.
October 22	<p>SEC Chairman meets with Mr. Niemeier.</p> <p>Judge Webster meets with remaining Commissioners in person or by telephone. Judge Webster meets separately with the SEC General Counsel to discuss the full-time nature of PCAOB service and what that would entail.</p>

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<b>Date (2002)</b>	<b>Event</b>
October 23	<p>A Commissioner requests that the SEC Chairman schedule an open meeting for the PCAOB vote. The Chairman schedules the open meeting for 2 p.m. on October 25.</p> <p>Judge Webster agrees in the evening to be PCAOB chairman.</p> <p>Chief Accountant leaves messages for Mr. Gradison and Mr. Goelzer regarding "exciting news." Mr. Gradison returns the call the following morning, and the Chief Accountant informs him of his nomination.</p>
October 24	<p>Chief Accountant and the SEC Chairman recommend terms of office for board members.</p> <p>Chief Accountant asks member of his staff to look again into the U.S. Technologies filings and enforcement actions.</p> <p>Chief Accountant informs Ms. Gillan of her nomination to the board. Also, the SEC General Counsel does a verbal background check over the telephone.</p> <p>SEC Chairman calls the Chairman of the Board of Governors of the Federal Reserve System and informs him that Judge Webster has accepted the PCAOB chairmanship. Later that day, the SEC Chairman provides the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury with the names of the four other nominees and asks them for letters endorsing SEC's selections to the PCAOB.</p> <p>Office of the General Counsel completes search of Name Relationship Search Index database for information on 17 finalists for the PCAOB.</p>
October 25	<p>Staff from the Office of the Chief Accountant provides the Chief Accountant with an overview of information collected on U.S. Technologies.</p> <p>Mr. Niemeier finds out that he has been selected for the PCAOB the morning of the vote.</p> <p>Commissioners see final slate and are formally told that vetting will occur post-appointment. Also, PCAOB nominees find out for the first time the names of their fellow board members.</p> <p>Judge Webster, Ms. Gillan, Mr. Goelzer, Mr. Gradison, and Mr. Niemeier are appointed to the PCAOB at the SEC open meeting.</p>
October 28	<p>Judge Webster telephones the SEC Chairman to inform him that law enforcement officers had seized equipment and records at U.S. Technologies's offices.</p>

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<b>Date (2002)</b>	<b>Event</b>
October 30	SEC press office receives an inquiry from <i>The New York Times</i> seeking comment on the content of an article it plans to print the following day concerning a criminal fraud investigation at U.S. Technologies.
	Office of the Chief Accountant looks into whether the SEC Division of Corporation Finance reviewed the U.S. Technologies's Form 8-K and Form 8-K/A filings.
October 31	Article in <i>The New York Times</i> alleges that Judge Webster provided the SEC Chairman with detailed information about his role in U.S. Technologies when he met with him earlier in the month.
	SEC Chairman and at least one other Commissioner independently contact the SEC Office of the Inspector General to investigate these allegations.
	Commission also asked the SEC Office of the General Counsel to conduct an investigation into Judge Webster's involvement with U.S. Technologies.
November 1	SEC General Counsel outlines for the Commission the specific steps his staff are taking to examine the backgrounds of each PCAOB appointee.
November 5	SEC Chairman resigns.
November 6	SEC Office of the General Counsel sends out vetting questionnaires to PCAOB members with a deadline of November 15 for submission.
November 8	Chief Accountant resigns.
November 12	Judge Webster resigns as chairman of the PCAOB.
November 13	PCAOB holds planning meeting that includes Judge Webster.
November 14	Office of the General Counsel sends out supplemental questionnaires to PCAOB members with a deadline of November 20 for submissions.
November 15	All questionnaires have been sent to CRM, the contractor SEC hired to conduct background investigations.
November 20	Office of the General Counsel sends Ms. Gillan's and Messrs. Niemeier's, Gradison's, and Goelzer's supplemental questionnaires to CRM.
November 29	Article in <i>The Wall Street Journal</i> reports on the role played by Arthur Levitt in supporting Mr. Biggs.
December 2	PCAOB holds its second planning meeting that includes Judge Webster.
	CRM briefs the Office of the General Counsel on its preliminary findings and indicates that it will provide a more formal report on December 12.
December 31	CRM is to provide a final report on the supplemental questionnaires to the Office of the General Counsel by this date.

<sup>a</sup>Stakeholders included Members of Congress, the Chairman of the Board of Governors of the Federal Reserve, the Secretary of the Treasury, industry groups, senior-level SEC staff, self-regulatory organizations, witnesses from related congressional hearings, and others.

Source: GAO analysis of SEC documents, relevant interviews, and other information.

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