

PCAOB Release No. 2003-020

BRIEFING PAPER

OVERSIGHT OF NON-U.S. PUBLIC ACCOUNTING FIRMS

OCTOBER 28, 2003

Introduction

In the wake of several highly publicized financial reporting scandals, many jurisdictions, including the United States, have undertaken reforms in the oversight of the auditing profession designed to restore investor confidence and improve the accuracy and reliability of corporate reporting. Over the past several months, the Public Company Accounting Oversight Board has been engaged in a constructive dialogue with many of its foreign counterparts concerning these reforms and the possible development of a cooperative arrangement for the oversight of accounting firms that audit companies whose securities trade in public markets. This dialogue has demonstrated that the Board and its foreign counterparts share many of the same objectives. These include protecting investors, improving audit quality, ensuring effective and efficient oversight of audit firms, helping to restore the public trust in the auditing profession and buttressing the efficient functioning of the capital markets.

Underlying this convergence of views is the global nature of the capital markets. As witnessed in the recent past, the global nature of the capital markets allows the effects of a corporate reporting failure in one country to ripple through the financial markets of another, potentially causing substantial financial damage. In an effort to avert further reporting failures and to help promote the integrity of the capital markets throughout the world, the PCAOB seeks to become partners with its non-U.S. counterparts in the oversight of the audit firms that operate in the global capital markets.

To that end, the Board believes that it is in the public interest, and the interest of investors and the Board's non-U.S. counterparts, to develop an efficient and effective cooperative arrangement where reliance may be placed on the home country system to the maximum extent possible. Such an arrangement has the positive effects of reducing potential conflicts of laws and minimizing unnecessarily duplicative regulatory burdens and costs for accounting firms. It also has the added benefits of allowing oversight regimes to allocate their resources in the most cost effective manner while addressing some practical problems that oversight regimes would face, such as those posed by the use of non-native languages. Moreover, an arrangement based on mutual

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cooperation with other high quality regulatory systems respects the cultural and legal differences of the regulatory regimes that exist around the world.

Under a cooperative approach adopted by a non-U.S. jurisdiction, the PCAOB is willing to work with its non-U.S. counterpart with regard to the oversight of U.S. accounting firms that audit or play a substantial role in the audit of public companies in that non-U.S. jurisdiction.

The Board believes that a well designed cooperative approach would allow the Board effectively to fulfill its statutory responsibilities to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports for publicly held companies, without in any way vitiating any statutory authority granted to the Board.

This paper describes the broad parameters of the cooperative approach envisaged by the Board for the oversight of non-U.S. firms with respect to inspections, investigations and sanctions, registration, potential conflicts of laws and multinational audits. The paper also describes the Board's intended mechanisms to effect the cooperative approach, which will include proposed rules on how the Board will carry out its inspection, investigation (including sanctions) and registration responsibilities in the context of the cooperative framework. In order to provide non-U.S. accounting firms a reasonable amount of time to consider and prepare for implementation of the Board's final rules in these areas, the Board intends to propose these rules in the near future. The proposed rules would be subject to procedures mandated by law, including an opportunity for public notice and comment.

Inspections

The Board recognizes that the structure, size and mandate of other inspections systems vary and that not all jurisdictions have inspection programs that are independent of the auditing profession. The Board anticipates, however, that the cooperative approach it envisages would accommodate the variety of inspection systems found around the world. Broadly, the Board believes that reliance, to the maximum extent consistent with the principles described below, on the home country system of a firm is appropriate.

The Board intends to propose a rule that would permit varying degrees of reliance on a firm's home country system of inspections, based on a sliding scale: the more independent and robust a home country system, the higher the reliance on that system. The Board envisages a principles-based approach -- where the home country system's comportment with certain principles would be weighed in determining the independence and robustness of that system. These principles would include the

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adequacy and integrity of the system; the independence of the system's operation from the auditing profession; the independence of the system's source of funding; the transparency of the system; and the system's track record. In corresponding guidance to the proposed rule, the Board would endeavor to clarify these principles by providing examples.

The Board also envisages that, under a cooperative approach, before an inspection of a foreign firm begins, an inspection work program would be discussed and agreed upon between the home country inspecting entity of the firm and the outside regulator including work allocation and staffing which would vary depending on the independence and robustness of the home country system.^{1/} At a minimum, the PCAOB anticipates that an inspection work program would include, among other things, information concerning visiting inspection personnel from the outside regulator, if applicable (i.e., who they are, their function, and their timing). An inspection work program would also identify the procedures regarding the quality control system and audit and/or review engagements for public companies that the outside regulator wishes to have inspected (the work program "add-ons"). The Board also expects that an expert or experts in the other jurisdiction's standards, designated by that outside regulator, would participate in the work program add-ons, where considered necessary by the outside regulator.

Under a cooperative approach, the Board envisages that the outside regulator would request to review the home country inspecting entity's work papers for the "add-on" portion of the inspection work program. Other requests for additional documents also would be first channeled through the home country inspecting entity.

In order to ensure effective implementation, the Board believes that the confidentiality of documents and information in the hands of the outside regulator must be ensured. In the United States, non-U.S. regulatory authorities, audit firms and their clients may take comfort in the fact that all information and documents received by, or prepared by, the PCAOB in connection with an inspection or an investigation of a PCAOB registered firm are confidential and privileged under Section 105(b)(5) of the Sarbanes-Oxley Act (the "Act").

The Board also believes that foreign firms registered with the PCAOB should have the same rights as domestic registered firms. Under its cooperative approach, the Board envisages that, based upon the work of the home country inspecting system and any other work performed by the PCAOB staff, the Board would issue a PCAOB inspection report on the non-U.S. audit firm. Under Section 104 of the Act, all firms,

^{1/} When the PCAOB is seeking to inspect a registered non-U.S. accounting firm, the PCAOB would be the "outside regulator."

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foreign and domestic, will have the right to seek review by the U.S. Securities and Exchange Commission of certain aspects of PCAOB inspection reports.

Under a cooperative approach implemented by other jurisdictions, the PCAOB would inspect or assist in the inspection of U.S. firms that audit or play a substantial role in the audit of public companies in those jurisdictions.

Investigations and Sanctions

The Board believes that reliance, to the maximum extent consistent with the principles described above and to the extent permitted by both countries' laws, on the home country system of the firm to conduct investigations and disciplinary proceedings is appropriate. The Board, like all oversight systems, does not have unlimited resources to accomplish its objectives and mandates. It follows that conducting unnecessarily duplicative investigations and imposing unnecessarily duplicative disciplinary sanctions do not serve the interests of investors or the general public.

In order to minimize such unnecessarily duplicative regulatory burdens and costs and promote the efficient allocation of resources, the Board intends to propose a rule that would permit reliance, to the maximum extent consistent with the principles described above, on non-U.S. investigatory systems and disciplinary sanctions. When a non-U.S. disciplinary regime provides for appropriate sanctions of accounting firms and individuals and that regime adequately serves the public interest and protects investors, the Board intends to rely, as appropriate, on the work of the other disciplinary system. Certain circumstances, however, may require the PCAOB to conduct the investigation of an accounting firm relating to its audit of a U.S. public company or to impose sanctions beyond those imposed by the non-U.S. system. In doing so, the Board would consider the sanctions of the non-U.S. system when determining the appropriate sanction in the United States.

Under a cooperative approach implemented by other jurisdictions, the PCAOB would assist, to the extent permitted by applicable law, in investigations of U.S. accounting firms that audit or play a substantial role in the audit of public companies in non-U.S. jurisdictions. In addition, under a cooperative approach, other jurisdictions may wish to rely upon Board sanctions.

Registration

The Board intends to clarify that a non-U.S. firm could register with the PCAOB by submitting the required application to its home country registration entity, if required by that entity, which then would submit it to the PCAOB. To facilitate this process, the Board intends to propose a rule to modify its registration form to permit the inclusion of

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the name and address of the appropriate home country entity. In order to permit sufficient time for rulemaking and to allow non-U.S. firms additional time to understand the implications of registration and oversight by the Board, the Board intends to propose extending its deadline for registration by non-U.S. firms by 90 days.

Potential Conflicts of Law

The cooperative approach envisaged by the Board would also address potential conflicts of law which may arise in connection with an inspection or an investigation. The Board believes that it is appropriate that a cooperative approach respect the laws of other jurisdictions, to the extent possible. At the same time, every jurisdiction must be able to protect the participants in, and the integrity of, its capital markets as it deems necessary and appropriate. Thus, the Board believes that a cooperative approach in which the outside regulator works in the first instance with the home country system to attempt to resolve potential conflicts of laws reflects the appropriate balance between the interests of different systems and their laws. The Board anticipates that most potential conflicts of laws may be resolved in this way or through the use of special procedures such as voluntary consents and waivers.

The Board believes that this approach would allow the Board to carry out effectively its statutory obligations without in any way vitiating the authority granted to the Board to seek the information necessary for it to fulfill its statutory mandate.

With respect to conflicts of laws in the context of registration, as discussed in the Board's registration release No. 2003-007, the Board adopted Rule 2105, *Conflicting Non-U.S. Laws*. This rule permits a registration applicant to withhold required information, if providing the information would violate a non-U.S. law.

Multinational Audits

In many cases, the auditing procedures needed to complete an audit of a multinational company are performed by accounting firms in many countries. The Board's interim auditing and related professional practice standards include an auditing standard that governs a registered public accounting firm's responsibilities when a part of the audit is performed by other independent auditors. Consistent with the Board's previous statement concerning consideration of its interim standards, the Board intends to consider a registered public accounting firm's responsibility for the work performed by other independent auditors, in the context of this interim auditing standard, and the audit documentation that the registered public accounting firm must have access to and maintain in this regard. The result of the Board's consideration may result in a revision of this interim standard.

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Conclusion

As previously noted, the Board believes that a cooperative approach to regulating audit firms that operate in the global capital markets benefits all interested parties. It provides for the protection of investors through improved audit quality and corporate reporting while minimizing unnecessarily duplicative regulatory burdens and costs, respecting cultural differences and allowing for the efficient allocation of resources. The Board regards the cooperative approach as the beginning of a long and mutually beneficial relationship between the Board and its counterparts around the world.

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Board

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.