



Public Company Accounting Oversight Board

Speech Text - Auditor Oversight and its Implications on the Resilience of our Capital Markets

by Chairman Mark W. Olson

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I appreciate the opportunity to join you this morning to discuss auditor oversight and its implications on the investor confidence in our capital markets. Financial regulators and supervisors play a critical role in strengthening the infrastructure of our markets, including by enhancing the reliability of financial information. On that note, I specifically would like to share with you today some thoughts on how the efforts of the Public Company Accounting Oversight Board (or PCAOB) and counterpart bodies around the world can strengthen confidence in audited financial statements.

For those of you who are less familiar with the PCAOB, I'll start with a very brief description of the PCAOB and why we were created. Before I continue, though, I should note that the views I express today are my own, and not necessarily those of other Board members or staff of the PCAOB.

The Regulatory Environment in the United States

As in many other countries, the U.S. regulatory environment has developed over time through a series of responses to identified problems and, as a result, might be viewed as a measure of social values in the United States. Laws and regulations are often developed in reaction to large scale financial abuse in order to steady the course. The Sarbanes-Oxley Act of 2002, follows this pattern. In passing Sarbanes-Oxley, Congress sought to restore investor confidence and address serious gaps in the U.S. regulatory framework that were identified through the financial scandals of 2001-2002. Among other things, there was an increased recognition of the need to bolster internal controls over financial reporting and bring an enhanced focus to corporate governance.

The Sarbanes-Oxley Act established the PCAOB, which replaced the audit profession's self-regulatory model with an independent oversight system. This change was grounded in the importance placed on audited financial statements as a critical component of the financial system's integrity. The Act also called for the development of standards for audits of internal control over financial reporting in an effort to stem the risk of future reporting failures. It is worth noting, however, that U.S. companies have been required to have internal control over their accounting since the U.S. Congress enacted the Foreign Corrupt Practices Act in 1977. The Sarbanes-Oxley Act's requirement for management certifications of internal controls, annual management assessments of controls, and independent auditor attestations to those assessments, raised corporate responsibilities for internal control over financial reporting to a higher level.

The PCAOB

The PCAOB oversees the auditors of U.S. public companies (that is, companies that have chosen to list on U.S. stock exchanges or otherwise sell securities to the public and have reporting obligations with the Securities and Exchange Commission). In carrying out this responsibility, the PCAOB is guided by a fundamental objective of protecting those that invest in U.S. equity markets. The PCAOB works in tandem with the SEC and others in the United States in achieving this objective. The PCAOB does not set accounting standards or regulate disclosures by public companies; rather, its role is to improve the quality and reliability of audits of financial statements of public companies. By doing so, investors can have more confidence in those financial statements and, ultimately, in the integrity of the capital markets.

Now in its fourth year of operation, the PCAOB has established a strong foundation for its oversight of public company auditors. The PCAOB has registered more than 1,700 accounting firms that audit, or wish to audit, U.S. public companies. Once registered, these firms become subject to the PCAOB's regulatory programs and must use PCAOB standards when they audit public companies. The PCAOB is also responsible for establishing auditing, quality control, ethics and independence standards applicable to registered firms' audits of public companies.

Inspections

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Registered public accounting firms are subject to the Board's inspection program, a key element of the PCAOB's oversight. PCAOB inspections replaced the audit profession's previous peer reviews, which focused on compliance with applicable standards but did not address the overall audit environment. PCAOB inspections are risk-based and designed to identify auditing problems at an early stage and focus firms on correcting them. In short, we are taking a supervisory approach to our inspection program.

The inspection program has proven to be a constructive exchange among firms and the PCAOB, and concerns identified during inspections are often promptly addressed by the firm being inspected. Having served as a banking supervisor (and a banker), I can assure you that the open and frank dialogue that occurs through the inspection process is a critical component of effective supervisory oversight.

Oversight of Non-U.S. Registered Firms and Coordination with International Authorities

I am encouraged by the fact that many countries have undertaken similar efforts to enhance auditor oversight in recent years. This is critical in light of the fact that many audit firms operate in multiple countries. Countries have taken a variety of approaches in implementing their auditor oversight models, due in part to differences in legal and cultural foundations. All, however, share the objective of improving the public confidence in the credibility of audits of financial statements. Due to the increasingly global footprint of large audit firms and the increasing inter-relationships between capital markets, auditor oversight bodies must continue to find ways to enhance coordination of their work and exchange experiences. The PCAOB recognizes the importance of cross-border coordination and a global dialogue among auditor oversight bodies.

To illustrate the importance of regulatory coordination to the PCAOB, more than 700 of the firms registered with the PCAOB are in countries outside the United States, although they may be affiliated with large, U.S. based audit firms. As required by the Sarbanes-Oxley Act, many of these firms are registered with the PCAOB because they audit non-U.S. companies whose securities trade in U.S. markets and are required to file audited financial statements with the SEC. In addition, as also provided for in the Act, a number of other non-U.S. firms are registered because they audit or wish to audit significant non-U.S. subsidiaries of multinational U.S. companies. With respect to both categories of firms, the PCAOB continues to work closely with its foreign counterparts to optimize efficiency in the oversight of these non-US firms.

Under the PCAOB's rules, in appropriate cases, the PCAOB may rely on the inspections and other work of those oversight bodies in achieving its own oversight mandate.¹ In this regard, the PCAOB's requirements are similar to those provided within the European Union's Eighth Directive. Specifically, the PCAOB rules enable it to rely on the work of the home-country regulator and to assist non-U.S. authorities in their oversight of U.S. audit firms that are within the regulatory jurisdiction of the non-U.S. authorities.²

Reliance demands an open dialogue among counterparts, and the PCAOB understands the importance of maintaining close working relationships with its counterparts in other countries. The PCAOB's degree of reliance on home-country inspections is based on the independence and rigor of the home-country system of oversight and agreement between the PCAOB and the home-country regulator on the inspection work program for individual firms. The more independent and rigorous the home-country system, the more the PCAOB can rely on its counterpart to conduct an inspection of a PCAOB-registered firm.

We at the PCAOB continue to be keenly aware of the potential for duplicative regulatory costs and the sensitivity to having PCAOB personnel inspect the files of non-U.S. firms.

With regard to the specific subject of the PCAOB's coordination with the European Commission and its member states, as I mentioned, non-U.S. auditors that do business in the United States through their audits of U.S. companies have been required to register with the PCAOB. Similarly, absent derogation by the European Commission or the Member States, non-European auditors of European companies will be required to register with the relevant Member State authority under the new 8th Directive on Statutory Auditors. This presents an important – I would say critically important – challenge for the PCAOB and its European counterparts. We must continue to work together to minimize the burdens of duplicative and/or contradictory regulation at the same time that we fulfill our statutory obligations to investors and the public.

Early in its existence, the PCAOB held extensive discussions with the Internal Markets Directorate of the European Commission, and others involved in regulating financial reporting and auditing in Europe. On the basis of those discussions, the PCAOB developed and adopted a framework for oversight that depends, to the maximum extent possible, on cooperation among regulators.

It is in this regard, along with the many other changes taking place in corporate governance and financial regulation around the world, that I especially welcome the establishment of new, independent auditor oversight systems in the European Union and other countries. Not only will the creation of independent oversight systems in Europe and around the world enable more efficient regulation of global audit firms, it is important for investors who are also global. I commend the European Union for taking such an important step and support the Member States in their efforts to consistently implement the Directive. It is vital that we support each other in carrying out our mutual objective to enhance auditor oversight. As we move forward to further coordinate our work, we will continue to do so in support and recognition of our respective requirements, including those related to confidentiality and data protection.

Let me use this as a segue to the important subject of how we, as overseers of the audit profession, see our work intersecting with the vitality and integrity of capital markets.

Capital Markets

The efficient operation of markets for public investment is predicated upon the assumption that information reported to potential investors is accurate, timely, and that this information includes all information that would be important to a reasonable investor's investment decision. The average investor is not privy to the same information available to members of a company's management and board of

directors. As a result, those investors must rely, to some degree, on the work of independent auditors in order to obtain a level of confidence in reported results in making investment decisions.

Therefore, as supervisors of the auditors of public companies, our role in supporting the integrity of information used in the capital markets is to reduce the risks of financial reporting and auditing failures in the public securities market. If we are doing our jobs as supervisors of the audit profession correctly, we should provide greater stability, accountability and confidence to financial reporting and thereby the markets. If we are doing our jobs as supervisors of the audit profession correctly, we also must continually reassess our requirements with a careful look at their cost and benefit. As necessary, adjustments should be made in response to these periodic reassessments.

The volume of activity in capital markets in the United States and elsewhere has grown tremendously over the last decade. One contributing factor has been the increased demand for equities as the workforce in the United States continues to transition from defined benefit pension plans to company-sponsored defined contribution plans that allow employees to determine their investment strategy. Currently, more than half of all American households are invested in U.S. public companies, primarily through mutual funds (or "collective investment schemes" as they are typically known in Europe).³ Protecting investors is an important mission for us all, and even more so when we are protecting individual shareholders who are on fixed incomes and possess limited economic resources.

Today, our markets are more global than ever, and financial systems are increasingly more sophisticated and accessible. Cross border transactions have been greatly facilitated in recent years due to the removal of a number of barriers and technological advancements. This has, in turn, facilitated greater access by investors and companies to cross border markets, thus enhancing their ability to seek greater returns and diversify their portfolios. This increase in global mobility of funds means that we all have a stake in promoting vibrant, transparent markets. Supervisors and regulators must keep pace.

To this end, a healthy degree of competition among our markets should be embraced. Companies today are presented with more options when they are determining where to raise capital. Regulatory regimes, as well as local political and cultural influences, are often factored into this decision. Competition can force efficiencies, yet we should be wary of competition that is based on cost alone. Having the right balance of oversight and regulation promotes innovation and protects the long-term reliability, stability and depth of capital markets, so they can continue to attract investors and issuers worldwide.

While policy makers in the United States continue to place a high value on the growth and overall health of our capital markets, growth in other markets should also be viewed as a positive development, and one that certainly predates Sarbanes-Oxley. To be sure, many markets outside of the United States have risen to become global players, due to a number of factors, including, as I mentioned a moment ago, the ease of information exchange and the reduction of certain barriers to cross-border transactions.

What role does regulation play in this context? I firmly believe that regulation, if balanced, attracts capital and builds confidence in markets. In fact, from the U.S. perspective, we have seen that listings on the U.S. markets have continued to command a valuation premium.⁴ Indeed, in the two years since companies have been reporting and obtaining audits on their internal control, the amount of capital raised by non-U.S. companies on U.S. exchanges has grown, not shrunk as it did in the years directly after the scandals.⁵ Moreover, the United States continues to be a leader in financial innovation.⁶ We are aware, however, of the concerns, and we will continue to assess the costs of our requirements to identify and eliminate those that are unnecessary to achieve the intended benefits.

Conclusion

Four years after corporate scandals shocked investor confidence and the U.S. Congress passed the Sarbanes-Oxley Act, we can begin to evaluate the extent to which investors are recognizing improvement in the reliability of financial reporting. We are seeing restored investor confidence in financial reporting. We are also seeing audit firms realign their business models to focus on quality audit services and additional services that are consistent with maintaining appropriate levels of independence.

It is important to observe, however, that after any significant law or regulation is passed, there is a sorting out period in which we re-evaluate progress and consider the costs and benefits once more. The PCAOB is in that stage right now. We, along with the SEC and others, are carefully looking at the milestones we have achieved and reassessing the costs of certain requirements, such as those governing internal control over financial reporting.⁷ After a lengthy comment process, the PCAOB plans to release a revised standard in the coming months.⁸ The revisions to this standard will be designed to improve the efficiency and effectiveness of audits of internal control.

In an effort to bolster cross-border coordination, the PCAOB is also working to enhance understanding of its oversight program. Our efforts include plans to host a seminar for non-U.S. auditor regulators and government officials in Washington next year to provide a detailed overview of the PCAOB's programs and operations, with the ultimate goal of enhancing our mutual working relationships. We intend this to be the first of what may become an annual seminar covering all of our operations from inspections to enforcement to standard setting to rulemaking procedures to our funding arrangement. Now that the PCAOB has been fully operational for over three years, we hope that other countries may benefit from our experience, including those ranging from just starting to think about independent auditor oversight to those with an already fully functioning system.

We also intend to increase our level of participation in the recently established International Forum of Independent Audit Regulators, or IFIAR. As I have stressed throughout my remarks this morning, the PCAOB strongly believes that dialogue and cooperation among regulators is critical to the successful functioning of the global capital markets and benefits all participants in those markets. As most of you probably know, over the past few years the PCAOB and its counterparts have engaged in roundtables to share perspectives. More recently, the roundtable approach was further developed and replaced by IFIAR.

Importantly, IFIAR will provide a venue for regulators to come together to share ideas and experiences in order to promote collaboration in

regulatory activity. IFIAR has elected two very capable and accomplished gentlemen as its new chairman and vice-chairman – Mr. Jeffrey Lucy, who is the Chairman of the Australian Securities and Investments Commission, and Mr. Paul Boyle, the Chief Executive Officer of the UK's Financial Reporting Council. I congratulate both of them and look forward to working closely with them in the future. I can tell you that the PCAOB has already greatly benefited from the exchange of information and views at the previous meetings of regulators.

Public oversight of the audit profession remains a new development. I have stressed this morning the value that it brings in promoting confidence in our markets globally. Because of the global nature of the audit profession and the importance of our shared objective, allow me to reiterate how committed I personally am to furthering close and active working relationships with the PCAOB's counterparts.

Thank you again. I look forward to your questions and an interesting dialogue throughout the day.

¹ See PCAOB Rule 4012, Inspections of Foreign Registered Public Accounting Firms.

² See PCAOB Rule 4012, Inspections of Foreign Registered Public Accounting Firms.

³ See Equity Ownership in America: 2005 (November 2005), available at http://www.ici.org/pdf/rpt_05_equity_owners.pdf.

⁴ Remarks of Noreen Culhane, Executive Vice President, Global Corporate Client Group, New York Stock Exchange, printed in Ernst & Young, Accelerated Growth: Global IPO Trends 2006, at 26 (An “underlying motivation for most companies listing in the U.S. is the valuation premium (average 30 percent) that accrues as a result of adhering to high standards of governance.”).

⁵ See Cowan, Lynn, “Foreign Companies Cash in on U.S. Exchanges, Wall Street Journal, August 28, 2006, at C6.

⁶ International Monetary Fund, The Global Financial Stability Report, September 2006, Figure 4.15.

⁷ Section 404 of the **Sarbanes-Oxley Act** requires public companies to annually assess and publicly report on the effectiveness of their internal control over financial reporting. **PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements**, establishes the professional standards for auditors when conducting an audit of internal control over financial reporting.

⁸ See PCAOB News Release, Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements (May 17, 2006), available at http://www.pcaobus.org/News_and_Events/News/2006/05-17.aspx.

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