

## FEE Conference on Audit Regulation in Brussels

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### Introduction

It is a great pleasure to be with you today in Brussels -- a city with a profound sense of history that reaches back before the sixth century. Over its long life, Brussels has flourished as a regional and international crossroad. I believe it is therefore highly appropriate to be in this place today to discuss with you developments in international cooperation among auditor oversight bodies.

These are important times for trans-Atlantic cooperation in the financial services sector. The significant efforts to enhance relationships between the auditor oversight bodies in the European Union and the United States are particularly noteworthy. Cross-border cooperation among oversight bodies is fundamental to carrying out our shared supervisory mandates in a smart manner. In recognition of the importance of cross-border cooperation, last March European Commissioner Charlie McCreevy and I met in Washington to discuss steps to enhance cooperation between the PCAOB and European auditor oversight bodies. We each made a commitment to advance collaborative efforts in 2007, and I will outline for you this morning how the PCAOB is moving forward. I am pleased that Charlie and I are both addressing you today, as it underscores our close working relationship.

Our mutual oversight and cooperation also is fundamental to the global strengthening of audit quality, which is vital to the efficient operation of our increasingly inter-connected capital markets. Today more than ever, capital markets and their participants recognize the important role played by the audit profession. This view, in part, is due to the gatekeeper function that auditors are expected to serve for investors. With this gatekeeper function comes significant responsibilities, and it is the role of auditor oversight bodies to assess how well auditors meet those responsibilities.

Before I begin, please note that the views I express today are my own, and not necessarily those of other Board members or the PCAOB.

In the time I have today, I would like to address the impact that global developments are having on auditor oversight. First, I want to tell you about measures the PCAOB is preparing to take to enhance the PCAOB's working relationships with regulatory counterparts in Europe and elsewhere by sharing knowledge and broadening cooperation in the oversight of jointly registered audit firms. Next, I also will briefly discuss current developments in the area of accounting and audit standards convergence.

It should not come as a surprise when I tell you that global developments have a significant impact on the PCAOB. This is due, in part, to the global footprint of a number of U.S. public companies and their auditors. In addition to approximately 985 U.S. audit firms, more than 800 firms in 80-plus countries around the world have registered with the PCAOB - and their numbers continue to grow. This is because the Sarbanes-Oxley Act of 2002 requires firms that audit U.S. public companies (including foreign private issuers) to register with the PCAOB and undergo regular inspections. In addition, firms are required to register with the PCAOB if they play a substantial role in the preparation of an audit report with respect to a U.S. issuer. This would include, for instance, firms that audit significant non-U.S. subsidiaries of multinational U.S. companies. While over 800 non-U.S. firms are registered with the PCAOB, currently 230 of these firms are subject to PCAOB inspection on a triennial basis.<sup>1</sup>

Since the creation of the PCAOB almost five years ago, we have reached out to regulators and governments in other countries to develop relationships with our counterparts in connection with those inspections. This has worked well, and the PCAOB is fully committed to working closely with our counterparts. I also recognize that cooperation is a two-way street: The PCAOB understands that other auditor oversight bodies also face a cross-border oversight obligations, and the PCAOB stands ready to assist counterparts in fulfilling their regulatory mandates.

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I will take this opportunity to discuss efforts to create a PCAOB framework for moving toward full reliance on counterparts in meeting our inspections mandates for non-U.S. registered firms, and the PCAOB's ability to reciprocate by assisting counterparts in the oversight of U.S. audit firms where there is a common interest.

## Full Reliance

Just over three years ago, the PCAOB formally recognized the importance of cross-border cooperation when it adopted Rule 4012 ("Inspections of Foreign Registered Public Accounting Firms"). This rule sets forth the framework for the PCAOB to work with auditor oversight bodies in other countries in the conduct of inspections. Rule 4012 is principles-based and includes a general outline of the types of criteria that the PCAOB Board considers when determining how to work with another regulator.<sup>2</sup> The rule provides a sliding scale, so that the more independent and rigorous an oversight system, the more the PCAOB may rely on that system. The sliding scale was designed to accommodate the variety of oversight systems that were developing around the world at the time. I understand that the PCAOB's requirements in this area are similar to those provided in the European Union's Eighth Company Law Directive.

In developing Rule 4012, 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 and elsewhere. Since the adoption of Rule 4012, the PCAOB has worked with a growing number of counterparts in different regions of the world. Throughout, the Board has taken steps to ensure that its cross-border activities are tailored to satisfy its mandate with appropriate respect for foreign laws and regulatory systems. In jurisdictions where there is no independent audit regulator carrying out regular inspections, the PCAOB has coordinated with the host government before carrying out inspections of PCAOB-registered firms independently. The PCAOB conducts an on-site inspection only with home-country coordination.

In jurisdictions where there are established oversight bodies, the PCAOB has been able to collaborate with those regulators and conduct joint inspections. During a joint inspection, the home-country regulator leads the inspection, and the PCAOB participates as a member of their team. I believe that the PCAOB and its counterparts have benefited from these experiences, which have provided an opportunity to share our respective approaches to audit oversight.

Meanwhile, we have witnessed the evolution in auditor oversight around the world. Auditor oversight bodies are developing at a remarkable rate. We saw this just last spring when the PCAOB hosted an international auditor oversight knowledge sharing session with peers. Representatives from over 40 countries participated, which indicates the growing interest in this area.

Last year, I had the opportunity to meet with some of the leaders of the European audit oversight bodies at a meeting of the European Group of Audit Oversight Bodies (EGAOB) here in Brussels. It was a very constructive discussion. I also have had the opportunity since last spring to meet with counterparts from other parts of the world, including, for example, Canada, Japan, Korea, and Singapore. One thought that has resonated with me after each of these meetings is that working together – rather than separately - will make audit oversight stronger and better.

Since last year, the PCAOB has invested substantial effort in considering its framework for cross-border oversight. We understand the importance of working closely with our counterparts – not only to enhance audit quality through our common interest in audit firms that we both supervise, but also to leverage our respective resources. Taking into account these goals and the progress that we are seeing worldwide, the PCAOB challenged itself to create a framework for an approach that would enable us to move beyond joint inspections toward full reliance.

## Proposal

The product of that internal effort is a staff proposal that the Board is scheduled to consider on December 5th. I asked the PCAOB staff to develop a policy statement that articulates certain essential criteria that, if met, would permit the Board to place full reliance - under Rule 4012 - on the inspections programs of qualified auditor oversight entities from other countries. The policy statement, if adopted, would not be in the form of a new rule but rather further guidance on the implementation of Rule 4012. Nonetheless, because implementation of a full reliance approach would have implications for our counterparts and others, the proposal includes the opportunity for public comment. Obtaining comment from a broad range of interested parties, including comment on the proposed criteria and approach, is critical, in my view, to developing a viable approach to full reliance.

I strongly support the proposal and am confident that on December 5th the Board will approve releasing the proposal for public comment.

I would like to take a moment to briefly outline some of the key features of the staff proposal. I will focus my remarks principally on the term, "full reliance," and the proposed essential criteria to obtain full reliance.

## Definition of full reliance

A fundamental part of the thinking over the last year has been to consider what the term "full reliance" should mean in the context of PCAOB cross-border inspections. The staff proposal reflects an ultimate goal, consistent with U.S. requirements, to enable the PCAOB to rely fully on our counterparts, including our European colleagues, and for them to be able to fully rely upon us. In developing the proposal, the staff sought to achieve this goal while adhering to the requirements within the Sarbanes-Oxley Act and the need to protect the interests of investors.

Under the proposal, full reliance is defined as follows:

- In general, that the Board would rely upon a non-U.S. oversight entity to plan the inspection, carry out the inspection field work,

and make findings based on its fieldwork; and

- In addition, the Board would rely on the non-U.S. oversight entity to assess the firm's efforts after receipt of an inspection report to address any criticisms of or potential defects in its quality control system (referred to as the remediation process).

If full reliance is determined to be appropriate, aside from having the opportunity to observe portions of the inspection, the PCAOB's involvement in the field would be limited. Observations in some circumstances may be limited, simply, to consultation by the PCAOB inspection team with the non-U.S. inspectors.

I do not view the move toward full reliance as an "on/off switch." Among other things, as we move forward, there would need to be a transition period while the PCAOB and its counterparts would work on a bilateral basis to reach agreement on specific procedural matters. This would involve entering into bilateral agreements. Moreover, in order for both parties to understand each other's systems fully, we would seek, and provide in return, to conduct joint inspections as part of the transition process. We expect that our counterparts in return would want to undertake joint inspections of U.S. firms within their regulatory purview, and we would welcome that. As mentioned, the PCAOB has conducted joint inspections with a number of counterparts to date and has found the experience to be mutually beneficial. Assuming that they otherwise meet the criteria, my hope is that the PCAOB would begin the move toward full reliance by 2009 with those entities with which we have been able to conclude bilateral agreements and successfully conduct joint inspections.

It is important to understand that full reliance may not be feasible immediately for every oversight body, for example, because some are just initiating measures to establish their inspection programs. In most instances, cooperation would still be possible and other arrangements would be available.

In developing the staff proposal, careful consideration was given to certain provisions in Sarbanes-Oxley that require specific actions to be taken with respect to inspections. As the Board is bound by these requirements, staff sought, consistent with these requirements, to give maximum deference to the work of the home country auditor oversight body. This is an area where public comment would be especially important.

## **Key Criteria**

In addition to defining the concept of "full reliance," the proposal lays out criteria under the five principles set forth in Rule 4012. As contemplated, the PCAOB would apply these criteria when assessing non-U.S. auditor oversight bodies for the purpose of determining whether the Board may place full reliance on that system in the context of inspections. I understand that this is similar to how the European authorities will judge whether the PCAOB is "equivalent" to the requirements under the Eighth Directive. Like the Eighth Directive, the criteria necessarily would combine aspects of an entity's legal authority and how that authority is applied. I will provide you a general sense of the proposed criteria.

### ***The adequacy and integrity of the oversight system***

The first principle relates to the adequacy and integrity of a country's oversight system. It is fundamental to a sound and effective public auditor oversight system that it have as its mandate to work in the public interest to protect investors by seeking to improve audit quality. To gauge whether this is the case, the essential criteria would look at the mandate, resources, and legal authority of the oversight system. Let me emphasize that these are not measures to make sure all oversight systems look exactly the same as the PCAOB. We know that systems vary in shapes and sizes; what is essential is that the system has the authority and resources to effectively carry out its oversight mandate.

### ***The independence of the system's operation from the auditing profession***

The second principle under Rule 4012 relates to the independence of the system's operation from the auditing profession. The PCAOB was established in the aftermath of a failure in the profession's self-oversight. This is one reason why we take seriously the need for an oversight body to operate with independence. The proposal's criteria therefore would look at the make-up of the governing body and the inspections staff. The independence of both are critical to credible and effective oversight. Other auditor oversight bodies share this conviction regarding independent oversight. At the same time, some markets have a highly concentrated and competitive pool of audit expertise; and oversight bodies need to draw upon this expertise for effective oversight. After careful consideration, the staff proposal was drafted to reflect the need to assure independence while balancing the need for technical expertise in competitive markets.

### ***The independence of the system's source of funding***

The third principle relates to the independence of the system's funding. Because funding is essential to the continuity of operations of any oversight system, the proposal's criteria would seek to assess the nature of the oversight body's source of funding, for example, to factor whether the system has the ability to carry out its mandate without undue influence from the audit practitioners and/or audit firms under its supervision. The criteria would reflect an understanding that funding sources will vary from country to country and that in some countries funding may be provided by members of the auditing profession, as long as appropriate controls are in place. This is why part of the focus is on whether funding is mandatory and the ability to independently determine funding needs.

### ***The transparency of the system***

The fourth principle addresses the transparency of the oversight system. Due to the importance of providing information to investors and other stakeholders as a means of enhancing confidence in financial reporting, the transparency of an oversight system would be an important part of the proposal's criteria for full reliance. The proposal's criteria in this area would assess whether the oversight entity publicly discloses information on its structure, governance, policies and operations. With regard to operations, an important component of

the PCAOB inspections program is the report that it provides inspected firms. When I was a banker, I recognized that regulators have a unique vantage point, and therefore, I used examination reports and other regulatory information sources as a constructive way to identify areas where I could further improve my institution's controls and operations. I hope that as the PCAOB's program continues to evolve, firms will share this same view. It's also important to note that under Sarbanes-Oxley, the Board is required to make inspection information available to the public in appropriate detail.

### ***The system's historical performance***

The fifth principle relates to the oversight system's record of enforcement. The ability and willingness to enforce requirements – when necessary - is a vital component of any regulatory system. Consistent with Rule 4012, the proposal's criteria would weigh whether the oversight entity or the system within which it operates has a record of disciplinary proceedings and appropriate sanctions. Understandably, these criteria would come into play only for those more mature systems, which would be expected to have a record of investigating allegations of misconduct and, where appropriate, pursuing enforcement or disciplinary proceedings, including the imposition of sanctions that were appropriate under that system's governing laws.

### **Role of bilateral arrangements**

Because the proposed policy statement would set forth only the overall framework for moving toward full reliance, an important step in the overall process would – out of necessity - include the PCAOB working closely with its counterparts to develop bilateral arrangements. At this stage, I envision that these arrangements would need to address in greater detail the progression toward full reliance. Moreover, I would anticipate that mutual agreements would set forth other aspects of cooperative arrangements relevant to the facts and circumstances of each jurisdiction, including those that govern information sharing, confidentiality, and data protection.

### **Reciprocity**

The ability of regulatory authorities to cooperate in this way is not only critical from a financial stability perspective due to the global nature of firms, but also due to the importance of regulators avoiding unnecessary duplication. Such duplication can waste the limited resources of any regulator and be an unnecessary burden on regulated firms. Moreover, cooperation can strengthen oversight of firms. Therefore, the PCAOB has endeavored to cooperate as much as possible with its counterparts around the world.

The PCAOB understands that cooperation goes both ways. Thus, the PCAOB seeks not only to cooperate with authorities in other countries in executing its inspections of PCAOB-registered audit firms located outside of the United States but also to provide assistance, where possible, to other authorities in their inspection of firms located in the United States that are also registered with the PCAOB. Our counterparts' inspectors are welcome to conduct on-site inspections of U.S. firms that are within their regulatory jurisdiction, and we are prepared to assist our counterparts with these U.S. inspections.

In order to assist oversight bodies from other countries with their U.S. inspections, early on, the PCAOB adopted a rule reflecting its willingness to assist non-U.S. authorities, Rule 6001 ("Assisting Non-U.S. Authorities in Inspections"). This rule was adopted at the same time as Rule 4012 and provides that the PCAOB may, as it deems appropriate, assist a non-U.S. authority in its inspection of a registered U.S. firm. Working within the limitations of the Sarbanes-Oxley Act, this rule reflects the PCAOB's fundamental willingness to provide assistance to non-U.S. auditor oversight entities in connection with their inspections of U.S.-based audit firms.

The PCAOB is prepared to assist its counterparts in the inspection of registered U.S. firms that audit or play a substantial role in the audit of public companies in non-U.S. jurisdictions. Auditor oversight bodies need to be able to rely on each other. Again, our work in developing the full reliance proposal is founded on a fundamental understanding that cooperation must go both ways.

### **Convergence**

Let me talk for a moment about the recent rulemaking by the U.S. Securities and Exchange Commission that will have some impact on the PCAOB and our non-U.S. counterparts. Earlier this year the SEC issued both a proposed rule change and a concept release centering on financial statements prepared in accordance with International Financial Reporting Standards (IFRS). Recently, the SEC took an important step and adopted final rules that will allow foreign private issuers that prepare their financial statements in accordance with IFRS, as published by the International Accounting Standards Board (IASB), to drop the previously required reconciliation to U.S. generally accepted accounting principles (US GAAP). A related but separate SEC concept release sought feedback on whether the SEC should permit U.S. companies to prepare their financial statements in accordance with IFRS, as published by the IASB, rather than US GAAP. The comment period for this concept release closed on November 13th, and the SEC is still reviewing the issue in light of comments received.

We have been monitoring these two initiatives closely and considering implications which they may have on PCAOB audit standards or the audit of U.S. public companies more broadly. Among other things, the PCAOB discussed potential audit implications of the IFRS initiatives with its Standing Advisory Group in October. We are continuing to consider the possible implications on audit risk and on the PCAOB's auditing and related professional practice standards, including standards related to audit firms' systems of quality control, including Appendix K. Most significantly, if the SEC permits U.S. companies to accept filings under IFRS, the PCAOB will need to consider the potential challenges for auditors who will be expected to audit for compliance with IFRS.

### **Audit Standards**

As resolution of the question about accounting standards convergence draws nearer, questions increasingly arise regarding the need for globally accepted auditing standards, and what the PCAOB is doing with regard to the question of convergence.

Let me first stress that I recognize the benefits of having a common approach to auditing standards throughout the world. We are fortunate in that the fundamental underpinnings of the auditing standards used in many countries – including those in the International Standards on Auditing developed by the International Auditing and Assurance Board of the International Federation of Accountants – are the same or very similar.

It makes sense to not only avoid creating unnecessary differences in auditing standards applicable to listed companies, but to work to bring them closer together. With these objectives in mind, both the PCAOB and the IAASB participate in each organization's ongoing standard-setting dialogues.

Early in the PCAOB's inception, we established a relationship with IFAC standard-setting bodies. The PCAOB continues to participate in the activities of the IAASB and other standard-setting bodies within IFAC. Similarly, the Chairman of the IAASB participates as an observer to the PCAOB's Standing Advisory Group, which provides input and advice on the PCAOB's standard-setting activities. The IAASB perspective in the SAG discussions has been invaluable.

Efforts to align auditing standards have been productive. Even though they have not resulted in identical standards in the short term, the effort is resulting in a continual process of improvement to auditing standards. In my view, this can only lead to improvements in auditing, which should translate to enhanced benefits to investors and others who rely on audited financial information.

## Conclusion

I will close by emphasizing that I believe oversight bodies worldwide all have the same fundamental goals and seek the same outcomes – high quality auditing and increased confidence in financial reporting. This is because we all recognize that reliable financial statements, as supplemented by appropriate disclosures, provide confidence to investors worldwide so that they are in a position to make meaningful evaluations of investment opportunities. An auditor's assurance that the financials have been fairly presented in accordance with the prevailing accounting standards is a fundamental part of reliable financial reporting. These are elemental concepts across all of our markets. Because of the role that auditors play in our markets, many jurisdictions around the world have made the move toward independent oversight.

While there are challenges the profession and regulators need to continue to address, audit quality appears to be improving. Moreover, the work of independent auditor oversight bodies should – and I believe does - contribute to this improvement. Our work continues.

Independent auditor oversight bodies are investing in measures to deepen relationships with their counterparts, and the PCAOB is motivated to do its part. We've seen the contagion effect that financial reporting failures in one market can have on another, and understand that cross-border cooperation can minimize and even prevent such spiraling.

In the short time that I have served as Chairman of the PCAOB, I have witnessed developments in the PCAOB's relationships with other oversight bodies that are enormously reassuring. I am convinced that this positive momentum will continue, and the next couple of years should prove to be a watershed for cross-border cooperation among audit oversight bodies.

Thank you again. I look forward to a lively dialogue with you today.

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<sup>1</sup> Not all of the non-U.S. registered audit firms require routine inspection by the PCAOB because many of them registered with the PCAOB even though they do not currently audit a U.S. public company.

<sup>2</sup> See PCAOB Release No. 2003-024, Proposed Rules on Oversight of Non-U.S. Firms (December 10, 2003); PCAOB Release No. 2004-005, Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms (June 9, 2004).