

Testimony Concerning  
The Regulatory Dialogue Between the  
Public Company Accounting Oversight Board  
And the European Commission



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Chairman Oxley, Ranking Member Frank, and Members of the Committee:

I am pleased to appear before the House Financial Services Committee today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") to discuss the regulatory dialogue between the PCAOB and the European Union ("EU").

Two years ago the financial reporting scandals relating to Enron, Adelphia, WorldCom, and others, rocked the U.S. capital markets. As these problems were emerging publicly, the House Financial Services and Senate Banking Committees acted swiftly and decisively to restore public confidence in U.S. markets with the Sarbanes-Oxley Act of 2002 ("the Act").<sup>1/</sup> Title I of the Act established the PCAOB to oversee the auditors of public companies that have registered securities with, or file reports with, the Securities and Exchange Commission ("SEC" or the "Commission") in order to access the U.S. capital markets. When President Bush signed the law, he acknowledged the importance of the creation of the PCAOB by declaring that, "For the first time, the accounting profession will be regulated by an independent board. This board will set clear standards to uphold the integrity of public audits . . . ." <sup>2/</sup>

Both we and Europe have learned from experience that no borders can contain the losses and uncertainty that occur with large corporate failures, such as those of Enron, WorldCom, Royal Ahold and Parmalat. In the same way that our Congress took steps to restore the public's confidence in our markets, Commissioner Frits Bolkestein

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<sup>1/</sup> P.L. No. 107-204 (2002).

<sup>2/</sup> President's Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 Weekly Comp. Pres. Doc. 1283 (July 30, 2003).

of the European Commission ("EC") and Director-General Alexander Schaub of the European Commission's Internal Market Directorate-General have taken important steps to help restore confidence in European markets. As I will explain further in my testimony, we see ourselves as partners with EU regulators in restoring investor confidence, and we have developed a constructive working relationship with the EC to further our mutual objectives.

### **Introduction**

Today, the PCAOB is well on its way to maintaining, as required in the Act, a continuous program of auditor oversight "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."<sup>3/</sup>

To carry out this charge, the Act gives the Board significant powers. Specifically, the Board's powers include authority –

- to register public accounting firms that prepare or participate in the preparation of audit reports for issuers;<sup>4/</sup>
- to conduct inspections of registered public accounting firms;

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<sup>3/</sup> Sarbanes-Oxley Act, Section 101(a).

<sup>4/</sup> Under Section 2(a)(7) of the Act, the term "issuer" includes domestic public companies, whether listed on an exchange or not, and foreign private issuers that have either registered, or are in the process of registering, a class of securities with the Securities and Exchange Commission or are otherwise subject to Commission reporting requirements.

- to conduct investigations and disciplinary proceedings concerning, and to impose appropriate sanctions upon, registered public accounting firms and associated persons of such firms;
- to enforce compliance by registered public accounting firms and their associated persons with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
- to establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for U.S. issuers.<sup>5/</sup>

Many U.S. public companies, of course, have subsidiaries and branches outside the United States. While these off-shore operations often play a significant role in the financial picture of the U.S. company, they are usually audited by local accountants in the countries where the subsidiaries or branches are located. In addition, companies headquartered outside of the United States often access the U.S. capital markets to sell their securities to those who invest in our markets. Approximately 1,400 foreign private issuers cause their securities to trade in U.S. markets and are required to file audited financial statements with the SEC. Most of these companies are audited by local accounting firms in their home countries.<sup>6/</sup>

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<sup>5/</sup> Sarbanes-Oxley Act, Section 101(c).

<sup>6/</sup> See: <http://www.sec.gov/divisions/corpfin/internatl/companies.shtml>.

Our capital markets, and the securities that trade in them, have a particularly strong link to Europe. Next to Canada, Europe has the most public companies that have registered securities, and file reports, with the SEC. As of December 31, 2002, there were 333 such European companies. In 2002, those 333 companies were audited by 58 E.U.-based auditors.<sup>7/</sup> Forty-nine of those auditors are affiliated with large U.S. accounting firms.

### **Registration of Public Accounting Firms that Audit U.S. Public Companies**

As required by the Act, in April of 2003, the Board adopted rules on the registration of public accounting firms that audit public companies that register securities, or file reports, with the SEC. The SEC approved these rules in July of 2003.<sup>8/</sup> These rules require public accounting firms that prepare or issue, or play a substantial role in the preparation or issuance of, an audit report on the financial statements of such an issuer to register, irrespective of where those firms are located.<sup>9/</sup> The Board's decision to require the registration of non-U.S. firms that audit such issuers was consistent with the Act. Specifically, Section 106(a) of the Act provides that non-U.S. firms are subject to the Act and to the rules of the Board "to the same extent as a public accounting firm that is organized and operates under the laws of the United States."

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<sup>7/</sup> Id.

<sup>8/</sup> Order Approving Proposed Rules Relating to Registration System, SEC Rel. No. 34-48180 (Jul. 16, 2003).

<sup>9/</sup> PCAOB Rule 2100.

The Act does, however, give the Board certain flexibility with regard to how it satisfies the requirements of the Act in respect to non-U.S. firms. Accordingly, while the Act prescribed a date – October 22, 2003<sup>10/</sup> – after which public accounting firms could not lawfully audit a U.S. public company without being registered, the Board used its authority under the Act to delay the effective date of the registration requirement for non-U.S. firms to July 19, 2004, in order to provide those firms additional time to prepare for registration.<sup>11/</sup>

The Board's registration system will, for the first time, require non-U.S. public accounting firms to register with the Board as a condition of preparing, issuing, or playing a substantial role in the preparation or issuance of, audit reports on U.S. public companies. However, non-U.S. accountants that participate in the audit of U.S. issuers have long been subject to various U.S. requirements. For example –

- All financial statements filed with the Commission must be audited in accordance with U.S. auditing standards. This applies whether the report is filed by a domestic issuer or a foreign private issuer.<sup>12/</sup>

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<sup>10/</sup> Section 101(d) of the Act provided that the registration requirement should take effect 180 days after the Commission determined the Board capable of carrying out the requirements of Title I of the Act. Accordingly, the registration requirement took effect October 22, 2003.

<sup>11/</sup> PCAOB Rule 2100. The PCAOB has established resources, including a helpline and a dedicated e-mail account, for applicants to obtain answers to questions about the registration process.

<sup>12/</sup> Rule 2-02(b) of Regulation S-X, 17 C.F.R. 210.2-02(b).

- All firms that audit financial statements filed with the Commission must satisfy the SEC's independence requirements, whether the audit relates to a domestic issuer or a foreign private issuer.<sup>13/</sup>
- Non-U.S. public accounting firms that participate in audits of domestic or foreign private issuers are subject to Commission enforcement action for any violation of the U.S. federal securities laws.
- Before the Act replaced the profession's system of self-regulation with independent regulation by the Board, the SEC Practice Section of the American Institute of Certified Public Accountants required that its "member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms" provide the names of those associated firms and seek adoption by those associated firms of certain policies and procedures, including "inspection procedures" that provide for an expert in U.S. accounting, auditing, and independence requirements to review a sample of the associated firm's audit engagements relating to reports filed with the SEC.<sup>14/</sup>

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<sup>13/</sup> Rule 2-01 of Regulation S-X, 17 C.F.R. 210.2-01. The Commission has modified its auditor independence rules in some relatively minor respects to account for conflicts with foreign laws or to account for different conditions in non-U.S. jurisdictions.

<sup>14/</sup> See AICPA SEC Practice Section Manual ("SECPS") § 1000.08(n); SECPS § 1000.45, App. K.01(b).

- With respect to non-U.S. firms that are not affiliated with U.S. accounting firms, and thus are not subject to the SEC Practice Section requirements, the Commission staff has typically required such a firm to –
  - provide information on its size, location(s), practice and policies, and
  - engage an accounting firm that regularly practices before the Commission to review the firm's policies and represent to the Commission staff that the audit was properly planned and conducted in accordance with U.S. auditing standards.

While non-U.S. accounting firms that audit U.S. issuers have long been subject to U.S. securities laws and U.S. auditing standards, the Board has recognized that registration of those firms raises additional issues and entails additional administrative burdens. The Board therefore gave careful consideration to the impact of its rules on non-U.S. firms and crafted certain variances from its rules to accommodate conflicts in law and differences in approaches and custom.<sup>15/</sup> I will discuss some of those accommodations below. In part because of these accommodations, and in part because non-U.S. firms typically audit only a small number of U.S. public companies (limiting, in most instances, the amount of data the registration system requires), the

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<sup>15/</sup> Those variances are summarized in the Board's release accompanying its final rules on registration, PCAOB Rel. No. 2003-07, at 17-20 (April 24, 2003) (available at <http://www.pcaobus.org/rules/Release2003-007.pdf>).

registration applications of non-U.S. firms are relatively straightforward and ought not impose an undue burden.<sup>16/</sup>

Today, 840 firms are registered with the Board, including 35 non-U.S. firms from countries such as the United Kingdom, Germany and Hungary. More than 145 additional non-U.S. firms have applied for registration. As required by the Act and the Board's rules, the Board will act upon those applications within 45 days of when they were submitted.<sup>17/</sup> At this point, we expect that as many as 300 non-U.S. firms may register with the Board.

### **International Initiatives and the Dialogue with the EU**

As we prepared for registration of non-U.S. firms that audit issuers that have registered securities, and file reports, with the SEC, we also began to develop our approaches to our continuing oversight of those firms. Specifically, we commenced an ongoing dialogue with international regulators involved in auditor oversight to find ways to enhance the effectiveness of our oversight and also, where possible, minimize duplicative regulation by coordinating our programs with those regulators. We also embarked on several initiatives, based in large part on the development of ideas in this dialogue. These initiatives include adopting certain accommodations in our registration system to address the special issues that face non-U.S. firms and developing a

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<sup>16/</sup> The average number of issuer clients reported by non-U.S. firms that have submitted registration applications is 7.3; European firms that have submitted applications report an average of 4.3 issuer clients.

<sup>17/</sup> Sarbanes-Oxley Act, Section 102(c)(1); PCAOB Rule 2106(b).

cooperative framework for our oversight of non-U.S. firms that takes advantage of the assistance and expertise of local regulators.

The European Commission is facing the same issues relating to audit quality that we face. The Parmalat scandal, which came to light last December, galvanized investors in European securities to demand more reliable financial reporting and auditing. Given Commissioner Bolkestein's and Director-General Schaub's foresight to develop a European model for independent auditor oversight, it is not surprising that they proposed a model in the proposed 8<sup>th</sup> Company Law Directive that should fit well with our hopes to coordinate our oversight with other regulators.

Shortly after assuming his position as Chairman of the PCAOB, Chairman Bill McDonough initiated our dialogue with government representatives of a number of foreign countries to explore ways to accomplish the goals of the Sarbanes-Oxley Act with the cooperation of other regulators, in order to establish a robust system of international regulation and, at the same time, minimize unnecessarily duplicative regulation. Chairman McDonough's first step in this effort was to travel to Brussels, in September 2003, to meet with Commissioner Bolkestein and Director-General Schaub.<sup>18/</sup> In those early meetings, we confirmed that we and the EC share the objectives of protecting investors and restoring public confidence in our markets by improving the quality of audits and the reliability of financial reporting. Given how inter-related our markets are, this convergence of objectives is no surprise.

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<sup>18/</sup> We also had discussions with regulators in Canada, Australia, Japan and Switzerland.

Since September, our Chairman has met several times with Commissioner Bolkestein and Director-General Schaub, and our respective staffs have had numerous, productive meetings. Also, on March 25 of this year, Commissioner Bolkestein and our Chairman held, in Brussels, an unprecedented roundtable discussion with Member State representatives and others responsible for auditor oversight, from all current and acceding EU countries. We discussed, among other things, the key objectives of auditor oversight upon which we are all building our oversight systems.

### **Oversight of Non-U.S. Firms that Audit U.S. Public Companies**

As I mentioned earlier, our dialogue has already led to certain policy initiatives. The Board recognizes that registration, inspection, and as necessary, investigation, of non-U.S. firms present special issues. To better understand these issues, the Board held a roundtable in the spring of 2003 for an open discussion about the challenges the Board and non-U.S. firms will face.<sup>19/</sup>

Most of the concerns raised during the March 2003 roundtable, and in later conversations with the EC and others, related to the potential for duplicative oversight and conflicts in laws. For example, we have been told that in some countries privacy and other laws restrict auditors from providing some information that we require in registration applications. The Board's oversight of non-U.S. firms also raises practical

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<sup>19/</sup> The following governments, firms and organizations participated in the public roundtable meeting: European Commission; U.K. Department of Trade and Industry; Embassy of Switzerland; Embassy of Australia; Financial Services Agency (Japan); Canadian Public Accountability Board; Wirtschaftsprüferkammer (German Chamber of Accountants); Fédération des Experts Comptables (FEE); Ernst & Young (Brussels, Belgium); PricewaterhouseCoopers (Toronto, Canada); Deloitte Touche Tohmatsu (Santiago, Chile); KPMG (London); Pennsylvania Public Employees' Retirement System; and the State of Wisconsin Investment Board.

issues. For example, it may be difficult for the Board to implement an effective inspections program in other countries without assistance from local regulators, particularly when a firm maintains its records and conducts its audits in a language other than English.

The solution we fashioned to address these issues neither duplicates foreign regulation nor defers to it. Instead we sought to incorporate home-country regulation into a framework for our oversight of non-U.S. firms. As discussed above, the Board started by providing for some accommodations in our registration process for non-U.S. firms. First, the Board extended the deadline for registration of non-U.S. firms to July 19, 2004, in order to allow them additional time to gather the necessary information and further understand the Board's system of oversight.

Second, the Board adopted a rule that allows a firm to omit information from its application if disclosure would cause it to violate its home country law.<sup>20/</sup> An applicant that claims that submitting information as part of its application would cause it to violate non-U.S. laws may provide, instead, an exhibit to the application form that includes –

- a copy of the relevant portion of the conflicting non-U.S. law;
- a legal opinion that submitting the information would cause the applicant to violate the conflicting non-U.S. law; and
- an explanation of the applicant's efforts to seek consents or waivers to eliminate the conflict, if the withheld information could be provided to the

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<sup>20/</sup> PCAOB Rule 2105.

Board with a consent or a waiver, and a representation that the applicant was unable to obtain such consents or waivers.

Registration is only the beginning of our oversight of public accounting firms that audit U.S. issuers, however. In order to implement an effective program of continuing oversight of non-U.S. firms that audit such issuers, and based on our discussions with the EC and others, we have developed a cooperative framework that would allow the Board to gain insight from and rely on the inspection of a firm's home-country regulator based on a "sliding scale."<sup>21/</sup> Our goal is to provide the highest quality oversight while recognizing the differences in other countries' approaches toward auditor oversight. We believe that the sliding scale approach is both faithful to our statutory mandate and appropriately respectful of other regulatory systems.

The proposed approach would permit varying degrees of reliance on a firm's home-country system of inspections, depending upon the independence and rigor of that system. The Board may also, in appropriate circumstances, rely upon an investigation conducted, or a sanction imposed by, a non-U.S. authority. The Board would place the greatest reliance on those systems with the highest level of rigor and independence from the accounting profession. Conversely, the Board would participate more directly and rely less on those systems that are less independent of the accounting profession.

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<sup>21/</sup> Briefing Paper: Oversight of Non-U.S. Public Accounting Firms, PCAOB Rel. No. 2003-20 (Oct. 28, 2003) (See: <http://www.pcaobus.org/rules/Release2003-020.pdf>); Proposed Rules, PCAOB Rel. No. 2003-024 (Dec. 10, 2003) (See: <http://www.pcaobus.org/rules/Release2003-024.pdf>).

The Board's reliance would also depend on developing, with the home-country regulator, an inspection work program for non-U.S. firms selected for inspection. Under Section 104 of the Act, and the Board's rules, firms that audit fewer than 100 U.S. public companies must be inspected every three years. Most European firms that we expect to register audit significantly fewer than 100 U.S. public companies, and to our knowledge, none audit 100 or more. An inspection work program would prescribe procedures to evaluate a firm's quality controls and assess its compliance with U.S. laws and auditing standards in selected audit engagements relating to U.S. public companies. We recognize 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. We believe, however, that the cooperative approach the Board has proposed allows us an appropriate degree of flexibility.

In fact, the oversight system required by the EC's proposed 8<sup>th</sup> Company Law Directive appears to mesh quite well with the oversight system we are putting in place here in the United States. The 8<sup>th</sup> Directive would require external and independent oversight of auditors in a manner that is transparent, well-funded and "free from any possible undue influence by statutory auditors or audit firms."<sup>22/</sup> The 8<sup>th</sup> Directive would also provide for cooperation with other regulators.<sup>23/</sup> These provisions should substantially enhance our ability to coordinate with our European counterparts. We are

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<sup>22/</sup> 8th Directive, Ch. VII, Art. 29, ¶ 1.(b); and 8th Directive, Ch. IX, Art. 31, ¶ 7.

<sup>23/</sup> 8th Directive, Ch. XII, Art. 47.

engaging in discussions with oversight bodies of EU Member States to learn about those systems and facilitate the cooperation envisioned by the Board and the 8<sup>th</sup> Directive.

The 8<sup>th</sup> Directive would also require Member States to use the International Standards on Auditing as established by the International Auditing and Assurance Standards Board ("IAASB") for audits of EU financial statements.<sup>24/</sup> Both the PCAOB and the EC have been given observer positions with the IAASB, and we have offered the IAASB observer status on our standards-setting advisory group. Our mutual participation will enhance our dialogue on establishing high quality auditing and related professional practice standards.

Notwithstanding the cooperative framework I just described, non-U.S. accounting firms that wish to continue auditing companies whose securities trade on U.S. markets must comply with U.S. law, including by registering and cooperating with the PCAOB. In some jurisdictions, this may create a legal conflict. We expect, however, that the cooperative approach will go a long way toward resolving conflicts of law that may arise in connection with an inspection. In addition to consents and waivers, by working with the home-country regulator in the first instance to attempt to resolve any conflicts, it is our hope that most problems can be avoided.

While the assistance of non-U.S. regulators will help us achieve our specific objectives under the Act, true cooperation is a two-way street. The Board has previously stated that it is willing to assist non-U.S. regulators in their oversight of

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<sup>24/</sup> 8th Directive, Ch. VI, Art. 26.

accounting firms. Because the needs of every regulator are different, we plan to work out the details of our assistance through dialogue with individual regulators.

We still have much work ahead of us to establish lasting relationships and working protocols with other regulators, but the PCAOB is optimistic. Cooperation among regulators requires good will and flexibility. Our experience with the European Commission has demonstrated that European regulators share this view. We are confident that with the continuation of our open and constructive dialogue with the Member States of the European Union, we will be able to resolve issues so that together we can fulfill our important missions.