
STANDING ADVISORY GROUP MEETING
PANEL DISCUSSION – GLOBAL QUALITY CONTROL PRACTICES

FEBRUARY 27, 2008

INTRODUCTION

A panel of representatives from global audit networks will discuss quality control practices of their networks, including practices in the audits of financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") at the February 2008 meeting of the Standing Advisory Group ("SAG").^{1/} At its October 18, 2007 meeting, the SAG discussed Appendix K, one of the PCAOB's quality control standards related to global audit networks. The purpose of the February panel is to foster discussion about global audit networks and their quality control practices to help determine what changes might be needed to Appendix K or other quality control standards.

This paper provides background information and outlines the topics that the panelists will address. After the panelists' remarks, the SAG will have an opportunity for further discussion with the panelists.

Global Audit Networks

Many foreign private issuers are audited by foreign associated firms (also referred to as foreign network firms). Foreign associated firms are domiciled outside the United States and are associated with a U.S.–domiciled firm through membership in a global audit network. These foreign associated firms can be associated with other network firms, either domestic or foreign, in a variety of ways. In many instances, the foreign associated firms contract to use the same, or similar, firm name as that of the

^{1/} The large accounting firms often refer to their affiliation of firms domiciled in various countries as global audit networks.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

domestic network firm. Firms that use names that indicate affiliation in a global audit network may leave investors and other users of audit reports with the impression that the reputation of the global audit network or the U.S.–domiciled affiliate stands behind the audit report, or that the signing firm has met the quality control standards of the global audit network.^{2/}

Firms, including network firms that audit issuers, or play a substantial role in the audit of an issuer, must be registered with the PCAOB. In addition, under the Sarbanes-Oxley Act of 2002 ("the Act") and the Board's rules, a foreign associated firm, or an umbrella organization, even if not registered, may be, under certain circumstances, an associated person of another firm that is registered.

Quality Control Standards Related to Global Audit Networks

To address certain quality control concerns related to global audit networks, the American Institute of Certified Public Accountants' SEC Practice Section ("SECPS") issued Appendix K, *SECPS Member Firms With Foreign Associated Firms That Audit SEC Registrants*, in 1999. PCAOB registered firms that were members of the SECPS are required to seek adoption of policies and procedures by the international organizations^{3/} or individual foreign associated firms that are consistent with the objectives set forth in Appendix K for audits of SEC registrants, according to SECPS Requirement of Membership Section 1000.08(n), adopted as part of the Board's interim

^{2/} The reputational risk of association with other firms in a global audit network, in some cases, has led associated firms to sever network ties when one associated firm has been involved in an accounting scandal. See, e.g., Clay Chandler, "Bank of China Hong Kong Dumps Andersen," *Washington Post* (April 11, 2002) (reporting the view that changing auditors after revelations of Arthur Andersen's role in the Enron accounting scandal in the United States "was a prudent move" because "the accounting firm's credibility was so damaged that investors would doubt the work of its foreign affiliates"); Dave Carpenter, "Andersen's accountants in New Zealand, Hong Kong, China, Russia bolt for rivals," *Associated Press* (March 22, 2002) ("Andersen affiliates have been discussing combinations with competitors since the American arm of the Andersen Worldwide group was indicted...Under Andersen's structure, the affiliates outside the United States are not involved in the Enron scandal, although the damage to the brand name has been widely felt.")

^{3/} Global audit networks are international organizations.

quality control standards.^{4/} An October 18, 2007 SAG briefing paper describes the policies and procedures contained in Appendix K.^{5/}

Global Audit Networks' Role in Implementation of International Financial Reporting Standards

To maintain the quality and reliability of audit reports on IFRS financial statements, some global audit networks have created global offices to consult on IFRS issues and implementation with affiliated network firms. At the firms' discretion, in some cases, these offices perform the Appendix K filing reviews on behalf of registered firms subject to Appendix K for filings that include financial statements prepared in accordance with IFRS. At the October 2007 SAG meeting, certain members also noted that some global audit networks have instituted a credentialing system to ensure that auditors from foreign member firms that assist U.S. member firms on audits of financial statements filed with the SEC have the requisite knowledge of applicable accounting and financial reporting requirements, PCAOB standards, and independence requirements.

Recent SEC actions have implications regarding global audit networks' quality controls over audits of financial statements presented under IFRS.^{6/} On November 15, 2007, the SEC approved rules that will permit foreign private issuers to file with the SEC financial statements prepared in accordance with IFRS, as issued by the International Accounting Standards Board ("IASB"), without reconciling those financial statements to U.S. GAAP.^{7/} Additionally, the SEC issued a concept release in August 2007 seeking comment on whether U.S.-domiciled public companies should be permitted to use

^{4/} PCAOB Rule 3400T describes the quality control standards that the Board adopted at that time. The interim quality control standards are available at <http://www.pcaobus.org/Standards/QC/Pages/default.aspx>.

^{5/} See SAG Briefing Paper at http://www.pcaobus.org/News/Events/Documents/10182007_SAGMeeting/IFRS_Briefing_Paper.pdf.

^{6/} See PCAOB speech at http://www.pcaobus.org/News/Speech/Pages/12102007_RayAICPANationalConference.aspx.

^{7/} See SEC Final Rule Release at <http://www.sec.gov/rules/final/2007/33-8879.pdf>.

IFRS, as issued by the IASB, for their SEC filings.^{8/} At its October 2007 meeting, the SAG discussed certain possible implications of the SEC's actions to the Board's quality control standards, including Appendix K.

The SEC's concept release discussed the "investment necessary to ensure that audits of financial statements prepared in accordance with IFRS are competently delivered and adequately supervised." The SEC further noted –

For audit firms that believe the benefits of the investment outweigh the associated costs, elements of their systems of quality control such as their practices related to hiring, assigning personnel to engagements, professional development and advancement activities would need to be adjusted. Because U.S. auditors have less experience with IFRS than with U.S. GAAP, in the short-term, audit firms may encounter challenges in establishing policies and procedures to provide them with reasonable assurance that their personnel possess knowledge appropriate to perform audits of U.S. issuers that apply IFRS. Even with appropriate systems of quality control, however, additional auditing guidance still may be necessary for auditors to appropriately address issues related to the transition to reporting on IFRS financial statements.

Additionally, for the U.S. firms that are members of global audit networks, systems of quality control need to foster the high quality and consistent application of IFRS across national borders.^{9/}

As part of the SEC's effort to gain an understanding of the quality of IFRS filings, the SEC staff recently undertook a review of certain IFRS filings in 2006. The SEC staff published its observations from that review in July 2007. Among other things, the SEC staff found –

...the vast majority of companies asserted compliance with a jurisdictional version of IFRS and that most also asserted compliance with IFRS as published by the International Accounting Standards Board, commonly referred to as the IASB. In the vast majority of the companies we

^{8/} See SEC Concept Release at <http://www.sec.gov/rules/concept/2007/33-8831.pdf>.

^{9/} See SEC Release No. 33-8831, *Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards*, at 33.

reviewed, the company's auditor opined on the company's compliance with the jurisdictional version of IFRS that the company used, but did not opine on the company's compliance with IFRS as published by the IASB.^{10/}

In addition, recent and ongoing surveys may also provide insight as to the challenges global audit networks face in addressing diversity in the application of IFRS and the divergence between IFRS and U.S. GAAP.^{11/} In particular, institutional investors surveyed in the EU report that EU companies that use IFRS provide improved and increased disclosure compared to home country filings but nevertheless also tend to continue to use home country accounting and financial reporting conventions, or so-called "nostalgic accounting."^{12/} Overall, the EU institutional investor survey concluded that –

...adoption of IFRS is good news for investors assuming that consistent practices emerge in terms of implementation – a condition which, two years after first-time adoption, has still not really been met. There is thus a challenge ahead for all market participants, including investors themselves who are perhaps the best placed to reward best practices and sanction bad ones. Auditors and market regulators should also play a key role in fostering convergence in implementation of the new standards and must devote adequate resources to that end if IFRS are to live up to their initial promise.^{13/}

^{10/} SEC, Staff Observations in the Review of IFRS Financial Statements (July 2, 2007), available at http://www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm; see also SEC, Staff Comments on Annual Reports Containing Financial Statements Prepared for the First Time on the Basis of International Financial Reporting Standards (updated Nov. 13, 2007), available at http://www.sec.gov/divisions/corpfin/ifrs_reviews.htm.

^{11/} See, e.g., Investor Perspectives on IFRS Implementation (December 2007), available at <http://www.afg.asso.fr/upload/3/Fichier735.pdf>; Elaine Henry, Stephen Lin, and Ya-Wen Yang, The European-U.S. GAAP Gap: Amount, type, homogeneity, and value relevance of IFRS to U.S. GAAP Form 20-F reconciliations (October 2007) (finding an increasing gap between IFRS and U.S. GAAP reporting); D. Jetuah, Citigroup lays out IFRS-US GAAP Gulf, Accountancy Age (August 30, 2007).

^{12/} See Investor Perspectives on IFRS Implementation at 7, *infra* note 11.

Panelists' Presentation Topics –

A panel of representatives from global audit networks will provide brief remarks and may address the following topics –

- Quality control mechanisms in place at the panelists' global audit networks that promote accurate and consistent application of accounting and financial reporting requirements in the audits of financial statements of issuers across the network and ensure that those audits are conducted in accordance with the federal securities law and PCAOB standards, including the following:
 - Intra-network inspection processes
 - Practices used to determine whether the network firms can rely on the audit practice of another network firm
 - Quality control practices related to audits of multi-national companies
 - The extent to which the U.S. network firm oversees, or is otherwise involved in, the work of a foreign network firm in an audit of a foreign private issuer
 - The role of global audit networks in the remediation of deficiencies identified in audits and quality control of member firms
- The extent to which the panelists' global audit networks have established global offices or other mechanisms to assist member firms with consistent implementation of IFRS in the various jurisdictions that have adopted or are adopting IFRS, including the following:
 - The roles played by such global offices
 - The extent to which such global offices assist in compliance with Appendix K

^{13/} Ibid. at 12.

SAG Discussion Questions –

1. What quality controls will best promote accurate and consistent application of accounting and financial reporting requirements in audits of financial statements of issuers across the network and ensure that those audits are conducted in accordance with the federal securities law and PCAOB standards?
2. What quality controls can investors and other users of audit reports reasonably expect from audit firms that use the names of, or otherwise indicate an affiliation with, PCAOB registered firms and their global audit networks?
3. Should PCAOB standards incorporate best practices or other improvements to enhance quality control over audits of multi-national companies?

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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.