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recognized that the oversight of registered non-U.S. firms raises special issues.<sup>2/</sup> To address these issues as they relate to inspections,<sup>3/</sup> the Board adopted PCAOB Rule 4012 ("Inspections of Foreign Registered Public Accounting Firms").<sup>4/</sup> Rule 4012 permits the Board to rely on independent audit oversight entities located in the home countries of registered non-U.S. audit firms in connection with required inspections and identifies five broad principles that guide the Board in making a reliance determination.

Consistent with Rule 4012, the Board has relied to a certain extent on auditor oversight entities in several jurisdictions over the past three years. During this same time period, there has been an evolution in auditor oversight around the world, and the Board has found that it shares a number of objectives with many of its new counterparts such as protecting investors, improving audit quality, ensuring effective oversight of audit firms and helping to restore the public trust in the auditing profession. Accordingly, the Board believes it is appropriate now to increase its level of reliance on non-U.S. oversight systems where possible. As a result, the Board proposes to issue the attached Proposed Policy Statement, "Guidance Regarding Implementation of PCAOB Rule 4012" (the "Policy Statement"), which articulates certain essential criteria that further define the principles set forth in Rule 4012 and, if met, will permit the Board to place full reliance on the inspections programs of qualified non-U.S. auditor oversight entities. The Board seeks public comment on the criteria and the approach described in the Policy Statement.

## II. Background

Rule 4012, which was adopted after a constructive dialogue in 2003 between the PCAOB and many of its foreign counterparts, sets forth a framework for cooperation

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<sup>2/</sup> See PCAOB Release No. 2003-007, Registration System for Public Accounting Firms (May 6, 2003); PCAOB Release No. 2004-005, Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms (June 9, 2004).

<sup>3/</sup> The Board's duties, including among others the registration and inspections of audit firms, and the establishment and enforcement of relevant rules and standards, are set forth generally in section 101(c) of the Act.

<sup>4/</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).

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with non-U.S. oversight entities in the context of inspections. The rule contains principles and illustrative criteria that guide the Board in making a determination about whether, and to what extent, the Board may rely on a non-U.S. oversight system in conducting inspections of PCAOB-registered non-U.S. audit firms.

The rule recognized that there are a variety of oversight systems that were developing around the world and permits the Board to adjust its reliance based upon the independence and rigor of the non-U.S. system. Thus, the framework set forth in Rule 4012 is based on a sliding scale: the more independent and rigorous the home-country oversight system, the greater the Board's reliance on that system. A higher level of reliance means less direct involvement by the Board in the inspection of the non-U.S. registered public accounting firms in that jurisdiction.

The rule is based on five principles that the Board developed to guide its evaluation of the independence and rigor of the home country system. The principles include (1) the adequacy and integrity of the oversight system, (2) the independence of the system's operation from the auditing profession, (3) the independence of the system's source of funding, (4) the transparency of the system and (5) the system's historical performance. The rule also contains a set of criteria for each principle that are intended to shed light on the types of factors that the Board may consider in an assessment of a non-U.S. system. In connection with the adoption of the rule, the Board stated that the presence or absence of one of the criteria listed in the rule is not necessarily determinative of the level of reliance that the Board may deem appropriate. The criteria were meant to be illustrative, not exhaustive. This was intended to permit the Board to avoid a check-the-box approach in assessing other systems.

Over the past three years, consistent with Rule 4012, the Board has placed reliance on auditor oversight entities in certain non-U.S. jurisdictions. In determining whether and how to increase its reliance on those and other oversight systems, the Board has carefully considered the requirements of the Act and the policies underlying the Board's mandate to protect the interests of investors. The Board also has reviewed the governing laws and frameworks of auditor oversight entities in other countries and has engaged in discussions with the representatives of foreign governments and oversight entities.

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### **III. Proposed Policy Statement**

The proposed Policy Statement explains the concept of full reliance. It articulates certain essential criteria that, if met, would allow the Board to move toward full reliance on a non-U.S. oversight entity in the context of inspections. If the Board finds a non-U.S. oversight entity has met the essential criteria set forth in the proposed policy statement, the Board expects to 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. In that instance, the Board also expects to 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. The Policy Statement explains the steps that the Board must take in order to comply with applicable requirements of the Sarbanes-Oxley Act. It is important to stress that, under full reliance, the Board will continue to coordinate closely with non-U.S. oversight entities, including, in some instances, observing the inspections by the non-U.S. oversight entities.

Prior to concluding that any non-U.S. oversight system is eligible for full reliance, the PCAOB staff will have had substantial dialogue with the non-U.S. oversight entity and become familiar with its structure, operations and approach to inspections. If it appears based on this review that the non-U.S. oversight entity is eligible for full reliance, the PCAOB then will negotiate a bilateral agreement with the non-U.S. oversight entity to set forth the anticipated progression toward full reliance, including a provision for joint inspections before full reliance can take effect.

### **IV. Questions**

Although the proposed Policy Statement is intended to provide further guidance about the Board's implementation of an existing rule, and therefore would not ordinarily be subject to a public notice and comment period, the Board believes that its policies on cross-border cooperation merit thorough discussion with all relevant stakeholders. Thus, the Board seeks public comment on all aspects of the draft Policy Statement.

1. If a non-U.S. auditor oversight entity meets the essential criteria set forth in the proposed Policy Statement, are there reasons why the Board should not increase its level of reliance on inspections conducted by such an independent non-U.S. oversight entity? What are the benefits and costs of full reliance?

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2. Are the essential criteria set forth in section III.C. of the Policy Statement appropriate? Are there additional factors that should be considered? Should the criteria be modified in any way?
3. Would meeting the essential criteria set forth in section III.C. – along with a satisfactory on-site assessment by the Board of the entity's inspection practices through a period of joint inspections – provide sufficient assurance that the oversight entity's inspection program merits full reliance?
4. The Board has carefully balanced the requirements of the Act and those of non-U.S. jurisdictions (including laws related to data protection, confidentiality and other important legal requirements). Are there additional differences between U.S. and non-U.S. auditor oversight regimes that should be considered? Would those differences suggest greater or less reliance?
5. As described in section III.B. of the Policy Statement, does the Policy Statement establish the appropriate nature and level of reliance?
6. Will the proposed approach adequately protect the interests of investors in U.S. issuers audited by non-U.S. audit firms?

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On the 5th day of December, in the year 2007, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

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J. Gordon Seymour  
Secretary

December 5, 2007

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APPENDIX 1 – Proposed Policy Statement: *Guidance Regarding Implementation of PCAOB Rule 4012*

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PROPOSED POLICY STATEMENT	)	
	)	
GUIDANCE REGARDING IMPLEMENTATION	)	December 5, 2007
OF PCAOB RULE 4012	)	
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**I. Introduction**

Pursuant to the Sarbanes-Oxley Act of 2002, the Public Company Accounting Oversight Board ("PCAOB" or "Board") is charged with the oversight of public accounting firms that provide audit services to U.S. public companies,<sup>1/</sup> regardless of where the firms are domiciled. Since its creation, the PCAOB has taken into account the special issues that arise in the oversight of non-U.S. audit firms. In adopting PCAOB Rule 4012 ("Inspections of Foreign Registered Public Accounting Firms") in 2004, the Board resolved that it would, where appropriate, rely on independent audit oversight entities located in the home countries of registered non-U.S. audit firms in connection with required inspections.

Over the past three years, consistent with Rule 4012, the Board has relied to a certain extent on auditor oversight entities in several jurisdictions. During this same time period, there has been an evolution in auditor oversight around the world, and the Board has found that it shares many objectives with its new counterparts such as protecting investors, improving audit quality, ensuring effective oversight of audit firms and helping to restore the public trust in the auditing profession. As more countries around the world join this effort, regulators can rely more readily on each other in

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<sup>1/</sup> This document uses the term "U.S. public companies" as shorthand for the companies that are "issuers" under the Act and the Board's rules. This 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.

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accomplishing their shared objectives. As a result, the Board believes it is now appropriate to increase its level of reliance on non-U.S. oversight systems where possible and intends to move toward full reliance on the inspections systems of qualified non-U.S. oversight entities.

This policy statement articulates the essential criteria that, if met, will permit the Board to place full reliance on the inspections programs of qualified non-U.S. auditor oversight entities. It also explains the concept of full reliance and the steps that the Board must take in order to ensure that it complies with applicable requirements of the Sarbanes-Oxley Act.

### **II. Background: Evolution of the PCAOB's Cross-Border Approach to Auditor Oversight**

Over the past five years, in response to various accounting scandals around the globe, many countries have taken steps to strengthen their systems of audit regulation in recognition of the fact that independent auditors play a key role in protecting investors and the public's interest in their respective capital markets. In the United States, Congress passed the Sarbanes-Oxley Act of 2002 (the "Act") which, among other reforms, established the PCAOB and gave it the responsibility 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>2/</sup> Many other countries have created or strengthened auditor oversight regimes. For example, in Europe, the European Union revised the Eighth Company Law Directive ("Eighth Directive") to require EU Member States to create a system of public oversight for statutory auditors by 2008.<sup>3/</sup> The provincial securities regulators in Canada created the Canadian Public Oversight Board ("CPAB"), and in Australia, the responsibilities of the Australian Securities and Investments Commission were expanded to include auditor oversight. In Asia, Japan created the Certified Public Accountants and Auditing Oversight Board ("CPA AOB"); Korea gave responsibility for

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<sup>2/</sup> The Sarbanes-Oxley Act, Section 101, 15 U.S.C. §7211.

<sup>3/</sup> See European Commission, Communication from the Commission to the Council and the European Parliament: Reinforcing the Statutory Audit in the EU (May 21, 2003); Directive 2006/43/EC of the European Parliament and of the Council of the European Union on statutory audits of annual accounts and consolidated accounts (May 17, 2006).

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auditor oversight to its Financial Supervisory Service; and Singapore created the Accounting and Corporate Regulatory Authority.

In Section 106 of the Act, Congress expressly directed the PCAOB to regulate non-U.S. public accounting firms that prepare audit reports for U.S. public companies, but it also permitted the Board, subject to approval by the Securities and Exchange Commission, to exempt foreign firms from provisions of the Act or rules issued under the Act.<sup>4/</sup> As a result, the Board considered carefully its approach to the oversight of non-U.S. public accounting firms. In 2003 and 2004, the Board engaged in discussions with a number of non-U.S. jurisdictions regarding their concerns about the Board's authority over non-U.S. firms. The Board also considered its public interest mandate and how that mandate related to non-U.S. audit firms.

The Board reached a number of conclusions. First, the Board decided not to exempt non-U.S. firms from registration with the PCAOB.<sup>5/</sup> Because registration with the PCAOB is the predicate to all of the Board's other oversight programs, an exemption from registration also would exempt a firm from complying with the PCAOB's auditing and other professional standards, inspections and disciplinary regimes. Moreover, even before the creation of the PCAOB, non-U.S. audit firms auditing U.S. issuers already had long been required to comply with certain U.S. legal requirements, such as the applicability of U.S. auditing standards, accounting rules and independence standards, and were subject to the jurisdiction of the SEC in certain situations. For these reasons – and because U.S. investors have the same interest in high quality auditing of the financial statements of issuers regardless of the physical location of the audit firm – the Board decided that it would not be in the public interest to provide an exemption from registration to firms located outside the U.S.<sup>6/</sup> Given the substantial number of firms that subsequently registered with the Board – over 800 firms from 86 countries to date – the Board continues to believe that its decision was the right one.

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<sup>4/</sup> The Sarbanes-Oxley Act, Section 106, 15 U.S.C. §7216.

<sup>5/</sup> See PCAOB Release No. 2003-007, Registration System for Public Accounting Firms (May 6, 2003).

<sup>6/</sup> See PCAOB Release No. 2003-007, Registration System for Public Accounting Firms (May 6, 2003).

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Second, the Board decided not to adopt an approach of mutual recognition whereby the Board would defer entirely to non-U.S. oversight entities' inspections, investigations and sanctions of registered non-U.S. firms.<sup>7/</sup> In light of its specific mission, the Board concluded that a comprehensive deferral to the home-country oversight entity regardless of circumstances would not be in the best interests of investors in U.S. issuers.

Nevertheless, the Board took several steps to ensure that its cross-border activities are narrowly tailored to satisfy its mandate while still respecting foreign law and regulatory systems. For example, early on during its existence, the Board gave non-U.S. firms additional time to register with the Board, and it eliminated certain information from the registration process for non-U.S. firms. In 2003, the Board issued Rule 2105 ("Conflicting Non-U.S. Laws"), which allows non-U.S. firms to withhold information from their registration applications if a conflict of law exists. This rule has been utilized by many non-U.S. firms and has further sensitized the Board to potential legal quandaries faced by non-U.S. firms.<sup>8/</sup>

In addition, the Board has endeavored to cooperate as much as possible with its counterparts around the world. The Board adopted Rules 6001 ("Assisting Non-U.S. Authorities in Inspections") and 6002 ("Assisting Non-U.S. Authorities in

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<sup>7/</sup> See PCAOB Release No. 2004-005, Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms (June 9, 2004).

<sup>8/</sup> The Board recognizes that potential conflicts of law may arise in connection with inspections of a non-U.S. registered firms. Although PCAOB Rule 2105 permits non-U.S. firms to withhold certain information from their initial registration with the firm if a legal conflict exists, this Rule does not apply to potential conflicts of law that may arise subsequent to registration. Nevertheless, the Board believes that it is appropriate that its approach to inspections of non-U.S. registered firms 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 it works in the first instance with the home country oversight system to attempt to resolve potential conflicts of laws reflects the appropriate balance between the interests of different systems and their laws. It has been the Board's experience that legal conflicts can be resolved in this way or through the use of special procedures such as voluntary consents or redaction.

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Investigations"), which reflect the Board's willingness to provide assistance to non-U.S. auditor oversight entities in connection with their inspections or investigations of U.S.-based audit firms, and Rule 5113 ("Reliance on the Investigations of Non-U.S. Authorities"), which reflects the Board's willingness to rely on a non-U.S. oversight entity in connection with an investigation or sanction. Finally, Rules 4011 ("Statement by Foreign Registered Public Accounting Firms") and 4012 – to be discussed in more detail below – set forth a framework under which the Board may rely, as appropriate, on inspections conducted by non-U.S. oversight entities.

Likewise, countries in other parts of the world are facilitating international cooperation among audit regulators. For example, in Australia, the Australian Securities and Investment Commission Amendment (Audit Inspection) Act 2007 specifically provides that ASIC may provide regulatory assistance to audit oversight entities from other countries. In Canada, CPAB decided early in its inception that regulatory cooperation was key and has been engaged since that time in the process of "setting up regular international meetings to facilitate international cooperation among national auditor oversight agencies."<sup>9/</sup> Similarly, recent legislative changes in Japan will allow its auditor oversight authority, the CPAAOB, to participate in cross-border cooperative arrangements. In Europe, the Eighth Directive specifically calls for cooperation between EU audit oversight bodies and other competent oversight authorities.<sup>10/</sup> Finally, in an effort to foster multilateral cooperation and coordination, the International Forum of Independent Audit Regulators was created in September 2006 with the aim of facilitating dialogue and the exchange of information among its member regulators from twenty-two countries.

### III. PCAOB Cross-Border Cooperation Policy Guidance

Having now entered its fifth year of operations, and in light of the many developments discussed above, the PCAOB believes it is appropriate to refine its policy of cross-border cooperation. With that goal in mind, this document provides additional guidance to non-U.S. oversight entities regarding the implementation of Rule 4012. This document identifies the factors relevant to "full reliance" by the Board on the

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<sup>9/</sup> Canadian Public Accountability Board, 2005 Annual Report 4 (2006).

<sup>10/</sup> Art. 33, 34 and 47 of the Directive 2006/43/EC of the European Parliament and of the Council of the European Union on statutory audits of annual accounts and consolidated accounts (May 17, 2006).

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inspections systems of its non-U.S. counterparts that are sufficiently rigorous to meet the level of protection for investors that is required by the Sarbanes-Oxley Act. This guidance does not depart from the underlying policy decisions made by the Board in issuing Rule 4012. Under that rule, the Board may increase reliance on non-U.S. oversight entities where appropriate while continuing to retain its overall authority under the Act over inspections, investigations, and enforcement.

While this policy guidance provides more information about the prerequisites for full reliance, it is in the interest of the Board to avoid a "check-the-box" approach and retain discretion to evaluate each oversight entity based on overarching principles. That being said, the Act does contain certain specific requirements, such as public reporting and remediation procedures that must be addressed by the non-U.S. oversight entity's process.

As set forth in more detail below, the Board's evaluation of the non-U.S. oversight entity for purposes of assessing whether full reliance is appropriate must necessarily involve a review of the legal framework under which the oversight entity operates, and an evaluation of how the entity's oversight authority is, in fact, applied. Relevant considerations will include, among others, the adequacy of funding of the oversight entity, its staffing level, the experience of its staff, the details of its inspections program and its historical performance. For these reasons, Rule 4012 is intended to be implemented bilaterally, on a country-by-country basis.

The progression toward full reliance must be deliberate. Not every oversight entity will necessarily meet the essential criteria immediately, but that will not foreclose the opportunity for the PCAOB to cooperate with such oversight bodies. Likewise, reliance may be less than full during the Board's early experiences with an oversight entity. Indeed, the Board requires that its staff gain a thorough understanding – including through working with the non-U.S. entity's staff through joint inspections – before recommending that the Board place full reliance on any particular non-U.S. oversight system. In jurisdictions where full reliance is not yet possible, the Board will continue to seek intermediate solutions for cooperation.

In the following sections, the Board first reviews the history and background of Rule 4012 and discusses its implementation thus far. The Board then discusses the concept of full reliance. Finally, the Board explains the Rule 4012 criteria that must be satisfied for the Board to place full reliance on a specific non-U.S. oversight entity.

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### A. *Background of PCAOB Rule 4012*

Rule 4012, which was adopted after a constructive dialogue in 2003 between the PCAOB and many of its foreign counterparts about reforms in the oversight of public accounting firms,<sup>11/</sup> sets forth a framework for cooperation with non-U.S. oversight entities in the context of inspections. The rule contains principles and illustrative criteria that guide the Board in making a determination about whether and to what extent the Board would rely on a non-U.S. oversight system in conducting inspections of PCAOB-registered non-U.S. audit firms.

The rule was intended to accommodate the variety of oversight systems that were developing around the world so that the Board could adjust its reliance based upon the independence and rigor of the non-U.S. system. Thus, the framework set forth in Rule 4012 is based on a sliding scale: the more independent and rigorous the home-country oversight system, the greater the Board's reliance on that system. A higher level of reliance means less direct involvement by the Board in the inspection of the non-U.S. registered public accounting firms in that jurisdiction.

The rule is based on five principles that the Board developed to guide its evaluation of the independence and rigor of the home country system. The principles include (1) the adequacy and integrity of the oversight system, (2) the independence of the system's operation from the auditing profession, (3) the independence of the system's source of funding, (4) the transparency of the system and (5) the system's historical performance. The rule also contains a set of criteria for each principle that are intended to shed light on the types of factors that the Board may consider in an assessment of a non-U.S. system. In connection with the adoption of the rule, the Board stated that the presence or absence of one of the criteria listed in the rule is not necessarily determinative of the level of reliance that the Board may deem appropriate. The criteria were meant to be illustrative, not exhaustive. This was intended to permit the Board to avoid a "check-the-box" approach in assessing other systems.

Thus far, the principles-based approach in the rule has served the Board well. It has permitted the Board to cooperate in inspections with other oversight entities in their early years when more Board involvement was expected. It has also permitted the

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<sup>11/</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).

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Board to adjust its participation as those oversight bodies have grown and evolved and the Board's understanding of their practices has deepened. While the Board is not changing the principles-based approach of Rule 4012 and will continue to look at the whole of every system when conducting an assessment, the Board believes that the satisfaction of certain criteria will be essential in order to place full reliance on another oversight entity's inspections work. Before moving to a discussion of these essential criteria, however, it is important to understand the concept of full reliance.

### *B. The Meaning of Full Reliance*

In the context of inspections, full reliance means, in general, that the Board will 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. In addition, the Board will 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. If full reliance is appropriate, aside from having the opportunity to observe portions of the inspection, the involvement in the inspections field work by the Board and the Board's staff will be limited. Observation may involve a range of activities and, depending on facts and circumstances, may vary by jurisdiction or inspection. For example, in some instances, PCAOB inspectors may simply consult with the non-U.S. oversight entity about its inspection plans or discuss with the non-U.S. inspectors any complicated or material inspection findings relevant to U.S. public companies. In other cases, PCAOB inspectors may request to accompany the non-U.S. inspection team to the audit firm for interviews with key firm personnel. Finally, there may be occasions when the PCAOB would request that the non-U.S. oversight entity allow PCAOB inspectors to review portions of the firm's audit work papers.

Although the Board intends to rely on non-U.S. oversight entities to the maximum extent possible, there are certain provisions in the Sarbanes-Oxley Act that require specific actions to be taken by the Board with respect to each inspection. Examples of these requirements include the publication of a firm-specific inspection report after giving the firm an opportunity to provide comments on a draft inspection report and giving the firm twelve-months to submit evidence that it has addressed any criticisms of or potential defects in its quality control systems. In a full reliance situation, however, the Board will request that the firm route its comments on the report and its evidence of remediation to the PCAOB through the non-U.S. oversight entity (or otherwise share its comments with the non-U.S. oversight entity), and, barring exceptional circumstances,

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the Board expects to base its required actions on the findings and assessments of the non-U.S. oversight entity.

### *C. Essential Criteria for Full Reliance*

Set forth below, organized under the five principles set forth in Rule 4012, are the essential criteria for a non-U.S. oversight entity to qualify for full reliance. A review of oversight systems around the world shows that many of them are developing structures and programs that address a high number of the criteria.

As mentioned above, certain of the criteria listed below are considered essential because the Sarbanes-Oxley Act includes specific requirements for the Board's oversight of registered non-U.S. public accounting firms. For example, Section 104(a) of the Act directs that an inspection must assess the degree of compliance by the registered audit firm with the Act, the rules of the Board and of the Securities and Exchange Commission, and professional standards in connection with the performance of audits, the issuance of audit reports, and related matters involving U.S. public companies. More particularly, Section 104(d) requires that an inspection include a review of selected U.S. public company audit engagements and an evaluation of the sufficiency of the quality control systems of firms and the manner of documentation and communication of that system by the firms. In this regard, the non-U.S. oversight entity also must be willing to consult with the PCAOB with regard to the selection of U.S. public company audit engagements. Finally, there are certain requirements with regard to the issuance of inspection reports to the firm and to the public (Section 104(f) and (g)) as well the remediation process (Section 104(g)(2)).

Although not required by a specific provision in the Act, other criteria are considered essential because the Board believes that the reliance determination must respect the broad principles underlying the establishment of the PCAOB and its mission. For example, as the Board noted in the analysis that accompanied the adoption of Rule 4012, Congress created the Board because the self-regulatory system then in existence in the United States had been discredited by numerous financial reporting failures. Therefore, one consideration relevant to the Board's assessment under Rule 4012 always has been whether the non-U.S. oversight system is independent of the audit profession. As noted below, a prerequisite for full reliance is that the oversight entity and its inspections staff, in particular, are independent of the audit profession. Other examples include a requirement that, to be effective, a non-U.S.

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oversight entity must have adequate funding, utilize qualified and experienced staff, and have the ability to access information and documents from a firm during an inspection.

While the Board has endeavored to craft the essential criteria as objective standards, some criteria will require the Board to exercise its judgment in determining whether they have been satisfied. This is unavoidable as some criteria are based upon ideals that do not easily lend themselves to a static, objective measure.

It is also important to note that, prior to concluding that any non-U.S. oversight system is eligible for full reliance, the PCAOB staff will have had substantial dialogue with the non-U.S. oversight entity and will have become familiar with its structure, operations and approach to inspections. If it appears based on that review that the non-U.S. oversight entity is eligible for full reliance, the PCAOB then will negotiate a bilateral agreement with the non-U.S. oversight entity to set forth the anticipated progression toward full reliance. The agreement will address cooperative arrangements that are appropriate given the facts and circumstances involved.<sup>12/</sup>

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<sup>12/</sup> The agreement also would include a provision for joint inspections to confirm the independence and rigor of the non-U.S. system before full reliance can take effect. In addition, the agreement should set forth the non-U.S. oversight entity's commitment to maintain the essential criteria on an on-going basis and the opportunity for the Board to observe, as described above. Through this process the PCAOB will ensure that reliance on the non-U.S. oversight entity meets the requirements of section 104 of the Act.

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### **Principle 1 - Adequacy and Integrity of the Non-U.S. System**

In assessing the adequacy and integrity of the non-U.S. oversight system, the Board weighs whether the non-U.S. system effectively works in the public interest to protect investors by seeking to improve audit quality.

#### Essential Criteria

1. The non-U.S. oversight entity must have a mandate to work in the public interest and protect investors by seeking to improve audit quality.
2. The non-U.S. oversight entity's management and governing body should be comprised of persons who are knowledgeable in the areas of financial markets, financial reporting or auditing.
3. The non-U.S. oversight system must have a quality assurance inspections program and the legal authority to ensure that audit firms within its regulatory jurisdiction are held accountable for conduct in contravention of applicable laws, regulations and professional standards.
4. The non-U.S. oversight system, including its inspections unit, must have adequate funding and sufficient staff given the size of the relevant capital market and the oversight entity's mandate.
5. The non-U.S. oversight system's inspections staff must have sufficient expertise, skills and experience in the audit field relative to the size and complexity of the audit firms within its mandate and must have sufficient expertise in applicable U.S. laws, regulations and professional standards.
6. The non-U.S. oversight system's inspection procedures must cover both a review of selected U.S. public company audit engagements and the firm's internal quality control system. The review in both areas must include an assessment of the firm's compliance with applicable U.S. laws, regulations and professional standards. The non-U.S. oversight entity must be willing to consult with the PCAOB with regard to the selection of U.S. public company audit engagements.

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7. The non-U.S. oversight entity must have the ability to access documents and information from the firm during an inspection.
8. The PCAOB must be given access, either by the non-U.S. oversight entity or by the PCAOB registered firm under inspection, to information and documents relevant to the inspection and oversight of the PCAOB registered firm.<sup>13/</sup>
9. The non-U.S. oversight entity must ensure that PCAOB-registered firms located in its country are inspected in accordance with the frequency requirements of the Sarbanes-Oxley Act.
10. The PCAOB must be given access to the non-U.S. oversight entity's written report to the firm of the oversight entity's inspection findings covering both its review of selected U.S. public company audit engagements and the firm's internal quality control system. The report to the firm should describe issues identified through the course of reviewing the firm's performance on selected U.S. public company audit engagements, such as apparent departures from applicable auditing standards, related attestation standards, ethical standards, independence standards, and the firm's own quality control policies and procedures. The report also should describe any criticisms of or potential defects in the firm's quality control systems.<sup>14/</sup>

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<sup>13/</sup> Relevant information includes the non-U.S. oversight entity's documentation of its inspection findings. In addition, although the PCAOB does not expect to request them routinely, the PCAOB must be given access to underlying audit work papers if requested. Appropriate measures relating to personal data protection will be taken through bilateral arrangements.

<sup>14/</sup> As noted above, in accordance with Section 104(f) of the Act, the PCAOB itself must issue an inspection report to the firm and provide the firm with an opportunity to comment on the report before it is issued as a final inspection report. As noted above, in a situation where full reliance is appropriate, the PCAOB would request that the firm route its comments on the report to the PCAOB through the non-U.S. oversight entity. Barring exceptional circumstances, the PCAOB expects to rely on the findings contained in the inspection report of the non-U.S. oversight entity.

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11. The non-U.S. oversight entity must have a process for assessing whether a firm has addressed any criticisms of or potential defects in the firm's quality control systems identified in the firm's inspection report.
  - a. The non-U.S. oversight entity must be willing to provide to the PCAOB an assessment of whether the firm, within twelve months from the issuance of the final inspection report, has demonstrated substantial, good faith progress toward achieving the relevant quality control objectives, sufficient to merit the result that the criticisms or potential defects remain non-public.
  - b. In the event that it is determined that the firm has not sufficiently addressed such criticisms or potential defects, the non-U.S. oversight entity must agree not to object to the PCAOB publicly disclosing the criticisms of or potential defects in the firm's quality control systems in order for the PCAOB to meet its statutory obligations.<sup>15/</sup>

### **Principle 2 - Independence of the Non-U.S. System**

In assessing the independence of the non-U.S. oversight entity and the system within which it operates, the Board weighs whether the operation of the entity and the system are free from interference or undue influence by the audit practitioners and/or audit firms under the entity's supervision.

#### Essential Criteria

1. The majority of the governing body of the non-U.S. oversight entity must be comprised of persons who are not current or former accountants or auditors or affiliated with an audit firm or the audit profession.
2. The management of the non-U.S. oversight entity must be comprised of persons who are not practicing auditors or affiliated with an audit firm.

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<sup>15/</sup> In a situation where full reliance is appropriate, barring exceptional circumstances, the PCAOB expects to rely on the non-U.S. oversight entity's remediation determination.

## RELEASE

3. The appointment and removal of the management of the non-U.S. oversight entity and the majority of the non-U.S. oversight entity's governing body must not be controlled, directed or unduly influenced by persons who are practicing auditors or affiliated with an audit firm or the audit profession.
4. The non-U.S. system's inspections staff must be comprised of persons who are not practicing auditors or affiliated with an audit firm and must, in performance of its inspections and reporting duties, be directly accountable to the management and/or governing body of the non-U.S. oversight entity.
5. The non-U.S. oversight entity must have in place prohibitions against conflicts of interest by its governing body, management and staff.
6. The day-to-day operations of the non-U.S. oversight entity must be conducted without the approval of or consultation with anyone who is a practicing auditor or affiliated with an audit firm.

### **Principle 3 - Source of the Non-U.S. System's Funding**

In assessing the nature of the non-U.S. oversight entity's source of funding, the Board weighs whether the non-U.S. system has the ability to obtain and deploy the financial resources necessary to carry out its mandate without interference or undue influence by the audit practitioners and/or audit firms under its supervision.

#### Essential Criteria

1. The level and source of funding and budget allocations for the non-U.S. oversight entity and its inspections staff must be determined without undue influence by persons who are currently practicing auditors or affiliated with an audit firm or the audit profession.
2. While funding may be provided by members of the audit profession, the obligation to provide funding must be mandatory and required to be paid on a timely basis.

## RELEASE

### **Principle 4 - Transparency of the Non-U.S. System**

In assessing the transparency of the non-U.S. oversight entity, the Board weighs the extent to which the entity is accountable for the discharge of its duties through a transparent framework. The Board reviews whether the entity publicly discloses information on its structure, governance, policies and operations.

#### Essential Criteria

1. The non-U.S. oversight entity must operate pursuant to a mandate that is publicly disclosed. Its objectives and authority must be defined in law, regulations or other publicly available materials.
2. The non-U.S. oversight entity must provide insight into its decisions and activities through a mechanism for public disclosure, such as periodic public reports.
3. The non-U.S. oversight entity must either issue public inspection reports on individual firms or agree not to object to the PCAOB issuing such reports based on information from the non-U.S. oversight entity's inspections.
  - a. The non-U.S. oversight entity issues public inspection reports on individual firms: If the non-U.S. oversight entity issues public inspection reports as described below, the Board intends to publish a reference to the non-U.S. entity's public report for each firm's inspection. The non-U.S. entity's report must, at a minimum, identify the firm(s) inspected and provide a summary of any major deficiencies identified for each firm related to the review of selected U.S. public company audit engagements where it appears that the firm did not obtain sufficient competent evidential matter to support its opinion(s).<sup>16/</sup>

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<sup>16/</sup> The public report need not follow the format of the public inspection reports issued by the PCAOB. In addition, the public report need not separately identify audit deficiencies related to U.S. public companies from those related to other companies reviewed during the non-U.S. oversight entity's inspection.

## RELEASE

- b. Non-U.S. oversight entity does not issue public inspection reports on individual firms: If the non-U.S. oversight entity does not issue public inspection reports for individual firms, it must agree not to object to the PCAOB issuing a public inspection report that identifies the firm inspected and provides a summary of any major deficiencies identified related to the review of selected U.S. public company audit engagements where it appears that the firm did not obtain sufficient competent evidential matter to support its opinion(s). The PCAOB will consult with the non-U.S. oversight entity about the content of such report.
4. In the event of non-remediation by the registered non-U.S. firm, the non-U.S. oversight entity must agree not to object to the PCAOB publicly disclosing the criticisms of and/or potential defects in the firm's quality control systems as set forth under Principle 1, Point 11.b. above.<sup>17/</sup>

### **Principle 5 - Historical Performance**

In assessing the historical performance of the non-U.S. oversight entity, the Board weighs whether the non-U.S. oversight entity or the system within which it operates has a record of disciplinary proceedings and appropriate sanctions.

#### Essential Criteria

1. More mature non-U.S. systems must have a record of investigating allegations of misconduct and, where appropriate, pursuing enforcement or disciplinary proceedings.
2. Where enforcement or disciplinary proceedings have been successful, the non-U.S. system must have imposed sanctions that were appropriate under the circumstances and the system's governing laws.

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<sup>17/</sup> As noted above, in a situation where full reliance is appropriate, barring exceptional circumstances, the PCAOB expects to rely on the non-U.S. oversight entity's remediation determination.