# Slides on Foreign Inspections
# prepared by IAG members
# Joseph Carcello, Barbara Roper, and Ann Yerger
# presented to the IAG on May 4, 2010

# Foreign Inspections Presentation to PCAOB Investor Advisory Group – May 4, 2010

Joseph V. Carcello
Corporate Governance Center
University of Tennessee

Barbara Roper
Consumer Federation of America

Ann Yerger
Council of Institutional Investors

# Outline for Presentation

- Background on the PCAOB's inspection program (Section 104 of SOX)
  - Mandate
  - Scope
  - Frequency
  - Background on foreign inspections
    - No exemptions
    - No full reliance
    - High cooperation

# Outline for Presentation

- Current state of foreign inspections
- Challenges posed by foreign inspections
- Number and size of foreign registrants on U.S. capital markets
- Relative size of international subsidiaries to large U.S. multinationals
- PCAOB inspection resources and rigor – U.S. firms vs. foreign firms

# Outline for Presentation

- Lack of access by PCAOB inspectors to certain foreign countries
- Independent audit regulators and their inspection regimes, including a rhetorical question for the group
- Recommendations for the PCAOB in this area
- Questions for the group

# PCAOB’s Inspection Program - Mandate

- “The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.”
- Inspections must inspect registered public accounting firms and “evaluate the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of that system by the firm.”

# Scope

- Covers any registered public accounting firm that audits a company traded on a U.S. exchange, regardless of domicile (there are registered firms that do not have any public company audit clients – such firms are not inspected).
- 2478 registered firms (as of 04/27/10), including 932 (or 38%) firms in 86 foreign countries

# Frequency

- Annually for any registered public accounting firm that regularly audits more than 100 issuers (total – 10, all located in the U.S.)
- At least once every 3 years for all other registered public accounting firms that have issued an audit report on an issuer during the preceding year (or played a substantial role in an audit of an issuer)
  - Approximately 450 firms in the U.S. and 200 firms outside the U.S.

# Background on Foreign Inspections

- No exemptions – all non-U.S. firms must register with the PCAOB if they audit a company traded on a U.S. exchange, or play a substantial role in the preparation or issuance of such reports (PCAOB Release No. 2003-007)
  - Ensures all firms comply with PCAOB auditing and other professional standards, inspections and disciplinary regimes

# Background on Foreign Inspections

- No full reliance – PCAOB does not defer entirely to non-U.S. oversight entities' inspections, investigations, and sanctions (PCAOB Release No. 2004-005)
  - PCAOB retains overall authority over inspections, investigations, and enforcement
  - PCAOB proposed conditions of full reliance approach in 2007 (PCAOB Release No. 2007-011); no action taken
- High cooperation – PCAOB cooperates as much as possible with its counterparts around the globe

# Current State of Foreign Inspections

- PCAOB Rule 4012
  - Board may rely on independent audit oversight entities located in home countries of registered non-U.S. audit firms
  - Degree of reliance depends on:
    - Adequacy and integrity of the oversight system
    - Independent operation of the oversight system
    - Independence of the system’s source of funding
    - Transparency of the system
    - System’s historical performance

# Challenges Posed by Foreign Inspections

- Not all registered non-U.S. firms have been inspected
  - As of 12-31-09, 70 foreign firms (in 25 foreign countries) had not been inspected even though more than 4 years had past since the end of the year in which the firm first issued a report while registered with the PCAOB
- PCAOB difficulties inspecting some registered non-U.S. firms
  - Access denied to PCAOB based on legal conflicts with home country laws or objections based on national sovereignty
- PCAOB solution:
  - Conduct joint inspections
  - Postpone certain non-U.S. inspections
  - Disclose names of firms not yet inspected
  - Disclose names of jurisdictions that deny access
  - Proposed legislation that would allow PCAOB to share documentation with other national audit regulators

# Challenges Posed by Foreign Inspections

- Largest auditing firms composed of global networks of affiliates
  - Affiliates are separate legal entities – independent and autonomous
  - Affiliates of a U.S. accounting firm may be subject to quality assurance, risk management, overall business reviews, codes of ethics and professional conduct, and practice rules
- Audits of global clients are handled by affiliated firms (or outsourced to non-affiliates and possibly non-registered non-U.S. firms) in jurisdictions of client operations

# Number and Size of Foreign Registrants on U.S. Capital Markets

- Foreign registrants audited by non-U.S. auditors are significant to the U.S. capital markets.  Total market cap for foreign registrants are approximately:
  - European Union and Norway – Over $500 billion
  - Switzerland – Over $75 billion
  - China and Hong Kong – Over $75 billion
- Do investors even know who many of the auditing firms are who are auditing large foreign registrants? (handout)

# Relative Size of International Subsidiaries to Large U.S. Multinationals

- We analyzed the geographic area disclosures (ASC 280 – Segment Reporting, f.k.a, FAS-131) for the *Fortune 100*
- These companies report a median (average) of 113 (251) subsidiaries of which 28 (95) represent foreign subsidiaries.
- If we include companies with no international revenues in our analysis:
  - Mean revenue from foreign operations to total revenue – 24%
  - Mean assets from foreign operations to total assets – 16%
- If we exclude companies with no international revenue from our analysis:
  - Mean revenue from foreign operations to total revenue – 36%
  - Mean assets from foreign operations to total assets – 30%

# PCAOB Inspection Resources and Rigor U.S. Firms vs. Foreign Firms

- Tried to compare PCAOB inspections of domestic firms with PCAOB inspections of foreign firms
  - Difficult to do with any degree of reliability using the public portions of inspection reports
- PCAOB's Office of Internal Oversight and Performance Assurance found (December 4, 2009):
  - Issues related to the rigor of some international inspections, particularly related to documentation, scope, consideration of risk, and reliance on foreign regulators
  - Until recently, a lack of a system of accountability

# Lack of Access by PCAOB Inspectors to Certain Foreign Countries

- PCAOB's ability to inspect foreign accounting firms in a number of countries has been blocked by the foreign government
- Among these countries where inspections are blocked are (global size rank based on GDP):
  - China ($3^{rd}$)
  - Germany ($4^{th}$)
  - France ($5^{th}$)
  - United Kingdom ($6^{th}$)

# Independent Audit Regulators and their Inspection Regimes

- Focused on examining the independent audit regulator in the 10 largest countries based on GDP (U.S., Japan, China, Germany, France, U.K., Italy, Brazil, Spain, Canada)
- Website content and other reporting was sporadic and inconsistent across the various countries
- Most useable reports were from U.S., Japan, U.K., Italy, and Canada
- Reports were not available in English for France and Germany and we were unable to locate reports for China, Brazil, and Spain

# Independent Audit Regulators and their Inspection Regimes

- It appeared that the board of the independent audit regulator was independent in the U.S., Japan, Germany, U.K., and Canada.
- The board does not appear to be independent in Italy and Brazil
- We could not determine if the board was independent in China, France, and Spain
- Japan and Canada do not issue separate inspection reports on the Big 4 firms but rather issue a combined report

# Independent Audit Regulators and their Inspection Regimes

- For the 2008 fiscal year, PCAOB operating expenses were approximately $134 million, compared to $9 million in Canada and $5 million in the U.K.
- In 2008, the PCAOB had 258 inspection employees, Japan had 39, Canada had 24 and the U.K. had 18
- In 2008, the PCAOB completed 255 inspections, the Canadian Public Accountability Board completed 42 inspections, and the Professional Oversight Board (U.K.) completed 19 inspections
  - 120 inspections were completed in Japan but they were by the JICPA, the profession's trade organization in Japan, similar in some respects to the AICPA peer review system in the U.S.

# Independent Audit Regulators and their Inspection Regimes

- In addition, reasoning by analogy, let’s compare the U.S. securities regulator with international securities regulators
- The SEC brought enforcement actions against approximately 300 companies between 1987 and 1997 (Beasley, Carcello, and Hermanson 1999)
- The SEC brought enforcement actions against 350 companies between 1998 and 2007 (Beasley, Carcello, Hermanson, and Neal 2010)
- Magnan, Cormier, and Lapointe-Antunes (2010) find only 15 enforcement actions by the Canadian securities regulator between 1995 and 2005

# Rhetorical Question

- Given the difference in the apparent rigor of the enforcement program between the U.S. securities regulator and at least one foreign counterpart, why should we expect the rigor of inspections between the U.S. independent audit regulator and foreign independent audit regulators to be any different?

# Recommendations for the PCAOB

- Redouble efforts to get access to these foreign accounting firms through political and diplomatic negotiations
  - The Board should not take any of its options off the table at this point (e.g., deregistering foreign accounting firms where inspections cannot be conducted)
- In the interim, the Board should require disclosure of:
  - Names of foreign registered accounting firms that have not been inspected (already being done)
  - Names of foreign registrants in countries where inspections have not occurred
  - Names of U.S. multinationals if material foreign subsidiaries have been audited by foreign accounting firms (often affiliates of the U.S. firm) that have not been inspected, and the percentages of consolidated revenues, income, and assets of foreign subs audited by foreign accounting firms that have not been inspected

# Recommendations for the PCAOB

- In addition, for foreign subsidiaries of U.S. multinationals audited by foreign affiliates of a U.S. firm the Board should:
  - Require the U.S. accounting firm to conduct detailed internal inspections of its foreign affiliates
  - Review these internal inspections
  - Expect its Division of Enforcement and Investigations to hold U.S. accounting firms responsible for the failures of their foreign affiliates when auditing material foreign subsidiaries of U.S. multinationals

# Questions

- Do you think that the PCAOB's foreign inspection process represents a risk to audit quality, and therefore to U.S. investors, including the Board's lack of access to firms in certain foreign jurisdictions?
- What other concerns with the foreign inspection process do you have?
- Are our recommendations to the Board reasonable and appropriate? Do they go far enough? What other steps might the Board take in this area?